S. Hrg. 100-578, Vol. II

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1989

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ECONOMICS

FEBRUARY 19, 1988
MARCH 4, 1988 } VIEWS OF THE REAGAN ADMINISTRATION

FEBRUARY 4, 1988—VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

MARCH 2, 1988—VIEWS OF THE FEDERAL RESERVE SYSTEM

TAXES

MARCH 31, 1988—THE TAX GAP

Volume II of III

Printed for the use of the Committee on the Budget

U.S. GOVERNMENT PRINTING OFFICE
83-885 WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S251-5

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VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

THURSDAY, FEBRUARY 4, 1988

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 3:16 p.m., in room 608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Johnston, Sasser, Exon, Wirth, Conrad, Domenici, Grassley, and Nickles.

Staff present: Richard N. Brandon, staff director; and Alan Cohen, assistant director for budget priorities.

For the minority: G. William Hoagland, staff director; and Gail Fosler, chief economist.

Chairman CHILES. Good afternoon.

Mr. Blum, we welcome you as this year's first witness before the Senate Budget Committee.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Somerset Maugham used to say that the only thing he was certain about was this, that there's very little about which he could be certain. Most likely, he would have felt very much at home on this committee.

We learned something about uncertainty last October 19th when the stock market collapsed. And those of us who were part of the Economic Summit were reminded constantly that what looked like an agreement in the morning could become gridlock by that afternoon.

Economic matters are always colored by uncertainty. The Congressional Budget Office, for example, tells us to expect weak economic growth, and that's the way things look to a lot of people. But you also suggest interest rates will be higher, and I can tell you there's some uncertainty, some difference of opinion about that.

You tell us the 1989 deficit will be around $176 billion, some $40 billion above the Gramm-Rudman-Hollings' target.

When we hear from the Office of Management and Budget in a couple of weeks, my guess is they're going to tell us the deficit will be somewhat less than you believe, and they'll tell us interest rates will be lower. Magically, I bet their estimates are just about Gramm-Rudman-Hollings on the nose.

We really can't be precisely certain about the size of the deficit, but there's one thing we can be sure about. It's still much too high.

And it's still too high, even after a budget summit that produced the largest amount of 2-year deficit reduction in our history. Still, the unified budget deficit is only half the story, the relatively pleasant half.

These days, we count the social security trust fund reserves when we calculate the deficit. Social security is running a substantial surplus, makes the overall Federal deficit seem smaller. As a matter of fact, I've already heard some talk about using that surplus to deal with the deficit. No way that's possible, of course, since the surplus is there to use when the "baby boom generation" retires in the next century.

So our overall problem is substantial. If we exclude social security reserves from our figures, we end up with a Federal funds deficit of $200 billion and climbing towards $230 billion in 5 years.

It seems to me that we're a long way from victory over the deficit. We won't win the battle piecemeal or 1 year at a time. Just in the few months between last year's summit and our hearing today, the economic forecast had changed to actually increase the apparent size of the deficit in the outyears.

We know that election year politics makes it unlikely we'll do much that's new this year. Instead of focusing on the $30 billion required annually under Gramm-Rudman-Hollings, let's focus on the $200 billion we need to solve the deficit problem once and for all. What we need is to start developing the options and come up with the blueprint for a major realignment of spending and revenue policies that would be required to truly get the deficit down to zero.

What does that mean for the work of this committee? It means we can't relax when the estimates improve or get too discouraged when the deficit proves tougher than we thought.

We're at a stage now in this struggle where continuity of will is critical. We'll make some progress and we'll have some setbacks. But each of those will turn out to be an impostor if we accept every turn of events as the end result.

The figures show that we're heading toward a $4 trillion national debt by 1993. That may be the direction we're heading, but we have the ability to change it.

In this hearing today, we'll be going through what amounts to the introduction to this year's budget debate. We'll have to fit the preliminary options into the overall debate, fit this year's budget into the long-haul process that eliminates the deficit altogether.

I know you'll be forthright in answering our questions, and I hope you'll be forceful throughout this year as we frame the plans to wipe out the deficit by a date certain.

Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator **Domenici**. Mr. Chairman, thank you very much.

Mr. Chairman, I want to first welcome Mr. Blum this afternoon. I know in his acting status he's in a very difficult position at a very difficult economic time, and I compliment him for the way he's handling CBO and himself.

I don't often quote economists, Mr. Chairman, least of all those with whom I have not agreed with in the past. But I'm told that, in his new book on "Economic Perspectives," John Kenneth Galbraith eloquently states, and I quote, "The most common qualification of the economic forecaster is not in knowing, but in knowing that he does not know. And his greatest advantage is that all predictions, right or wrong, are soon forgotten."

As we begin the hearing today, indeed as we begin this new budget cycle, I think it's worth our time to reflect on his observations.

You know that I have the utmost respect for the Congressional Budget Office. But I think your staff would agree that they can not tell the future. As stated more positively, at least they know that there's a wide confidence buffer zone around their estimates.

In CBO's Economic and Budget Outlook, Mr. Blum, which you updated last fall, you carefully detailed that the annual average error in the deficit estimates based solely on CBO's economic variables was $20 billion during the 1980's. I'm quoting your summary of your activities.

In addition, during the 1980's, the average annual error in the deficit forecasts associated with technical assumptions was nearly $9 billion. For policy assumptions, the annual average error was nearly $12 billion. The total average annual error in deficit forecasts then has been nearly $40 billion during the 1980's. I do not state this to say that you have a better or worse record than others, but merely to restate what you have already told us about yourselves.

Admittedly, each of the factors, economic, technical and policy, contributed to underestimates in the actual deficit during that period, not overestimates. But whatever the direction of the error, the error can be significant. You've estimated two times out of three your estimates can vary from the actual outcome by between $36 and $44 billion.

Now, I raise this issue here today, not to make a statistical point, but to help make a political point. Even when we thought we knew what was going on in the economy, there were wide variances in our deficit estimates. Every year is a new adventure in economic forecasting. Every year has its uncertainties. Some want to read certain recent economic statistics as an indication of how bad things are, or how bad things are going to be. Others look at the same statistics and find positive signs of continued growth, low inflation, robust expansion, and an export boom.

Even today, it will be reported that the Michigan survey of consumer sentiment index increased four full points to 90 points, which is just below the peak just before the October crash of Wall Street.

Mr. Chairman and Mr. Blum, I say that at this point in our Nation's economic history uncertainty is what economists are best at forecasting. Our economy is more complex and more integrated with other Nations than ever before in our history. And I believe you will acknowledge that.

I don't believe that that's necessarily bad, only that it makes your job and the job of CBO, and ultimately ours, Mr. Chairman, much more difficult.

Today, more than in the past, the fog of uncertainty hangs heavy across this hearing room. And frankly I believe you will agree that it also hangs heavy today over your testimony in terms of the economic assumptions.

I hope we have time, Mr. Chairman, to go through the current range of economic assumptions in this country, and then perhaps to even take a look at what we think OMB's might be. We're not sure. And maybe even though it's a short day, we would get some perspective quickly of what our problem is and what route we're seeking to follow.

I want to conclude by saying I start with a very simple premise, Mr. Chairman and members of the committee. I think we reached a very plausible and reasonable economic summit accord, and I want to make sure that Mr. Blum tells us we lived up to it in the first year. Then I personally hope this Budget Committee will have as its prime goal living up to it in the second year.

We reached agreement last year. We know where we want to go this year. And I hope our goal is enforcement of that economic summit across the board.

Having said that, I look forward to the testimony of Mr. Blum. And I compliment you for getting started and pledge to you that my goal is to work with you in an effort to get a budget resolution out quickly and get it passed.

Thank you, Mr. Chairman.

Chairman CHILES. That's good news to me. I'm glad to hear it. Mr. Blum.

STATEMENT OF JAMES L. BLUM, ACTING DIRECTOR AND ASSISTANT DIRECTOR FOR BUDGET ANALYSIS, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY ROSEMARY MARCUSS, ASSISTANT DIRECTOR, TAX ANALYSIS DIVISION; AND JOB DREYER, ASSISTANT DIRECTOR, FISCAL ANALYSIS DIVISION

Mr. BLUM. Thank you, Mr. Chairman. I am certainly pleased to appear this afternoon before the committee to discuss the economic and budget projections of the Congressional Budget Office.

Echoing Senator Domenici's remarks, it is with a certain amount of modesty and humility that we're here today to discuss our economic and budget projections. There is, of course, a great deal of uncertainty.

I think it's traditional for the Congressional Budget Office to say at this hearing at this time of the year that there is a great deal of uncertainty, and this year is no exception.

The projections that I will discuss today will be described in more detail in the CBO report titled "The Economic and Budget Outlook: Fiscal Years 1989-1993," which we plan to release on Thursday, February 11th.

In the closing days of 1987, the Congress and the administration negotiated and largely put in place a plan to reduce the budget deficit for 1988 and 1989. At the same time, in the wake of the stock market collapse, signs of the temporary weakness in the economy began to emerge. The Congressional Budget Office now anticipates that the economy will experience a pronounced slowdown in growth in early 1988, but will regain strength in the second half of

1988 and in 1989. On the basis of CBO's economic assumptions and a continuation of current budgetary policies, the Federal deficit is projected to rise from $149 billion in 1987 to $157 billion in 1988, and $176 billion in 1989, before dropping back to $167 billion in 1990.

These baseline budget projections assume that revenues, offsetting receipts and entitlement spending are projected according to laws now on the statute books. Defense and non-defense discretionary appropriations are assumed to be held constant in real terms. The baseline projections are, therefore, not forecasts of future budgets, which will doubtless include numerous policy changes. This year, the CBO has made minor changes in its baseline to make it identical to the budget base as specified in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987. We hope that having a single baseline will help focus attention on the fundamentals of the budget situation, and reduce any confusion stemming from minor conceptual differences that may have existed in the past.

On November 16th, as required by the Balanced Budget Act, CBO reported that the budget deficit for 1988 would be $180 billion under the laws then in effect. We also projected a deficit of $186 billion in 1989, and $166 billion in 1990. These estimates were based on our August economic and technical estimating assumptions. How have these budget estimates changed since November?

On November 20, as you are well aware, the congressional leaders and the President announced that they had reached a budget agreement covering the next 2-fiscal years. This agreement, or budget summit, was intended to reduce the deficit by $30 billion in 1988 and by $46 billion in 1989 from the Balanced Budget Act baseline. The results of the budget summit were almost entirely incorporated in two bills—the continuing resolution of appropriations and the Omnibus Budget Reconciliation Act of 1987—which were signed by the President on December 22. These laws reduced the deficit for 1988 by an estimated $34 billion, comprising $23 billion in lower spending and $11 billion in additional revenues. The projected deficit reduction then grows to $36 billion in 1989 and $40 billion in 1990, assuming that spending programs subject to annual appropriation action are allowed to grow by only the rate of inflation.

These numbers are shown below in table 1.[1] I would like to note that the $34 billion in savings for 1988 is over $3 billion in excess of the target that was in the budget summit agreement.

Chairman Chiles. Now, I think that's important. So your study shows, the savings we made were actually more than we said we would get in that summit agreement.

Mr. Blum. That's correct.

If everything else had stayed the same, those savings of $34 billion would have reduced the 1988 deficit to about $146 billion, and the 1989 deficit to about $150 billion.

But while the policymakers were working hard to reduce the deficit, a deterioration in the economic outlook was eroding some of these improvements. CBO's updated economic assumptions add $9 billion to the deficit in 1988, $21 billion in 1989, and $33 billion in 1990, compared with our November estimates. In 1988 and 1989, most of these changes result from lower tax revenues brought on by the forecast of a slowdown in economic growth. By 1990, however, the primary factor is a projected increase in interest rates, which adds to the cost of servicing the national debt.

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[1] See p. 14.

Changes in technical estimating methods and assumptions have also increased the projected deficit slightly—by $2 billion in 1988, $6 billion in 1989, and $8 billion in 1990, since our November estimates. These reestimates result primarily from newly available data that permit a better estimate of the effects of the Tax Reform Act of 1986. Technical revisions in outlay estimates, while large for some individual programs, are negligible in total in most years.

The recent policy actions and economic and technical reestimates have not changed the pattern of the projected deficit for this period. The deficit fell sharply in 1987, will rise in 1988 and 1989, and is projected to fall again in 1990. This jagged shape is largely the result of the phase-in of the Tax Reform Act of 1986 and of various one-time outlay savings. Tax reform added $22 billion to revenues in 1987, but reduces tax collections by $10 billion in 1988 and by $16 billion in 1989. Asset sales and other one-time spending cuts hold down outlays by $15 billion in 1987 and another $6 billion in 1988. The 1988 savings result from loan prepayments permitted by the recent appropriation and reconciliation bills. Were it not for these special factors, the pattern of the deficits would be much smoother, as shown in the bottom tier of table 1, and illustrated graphically in Figure 1.[1] The adjusted deficit would have fallen less sharply in 1987—to about $186 billion—and would then fall further to the range of $150 billion to $160 billion, where it would remain for the next several years.

The baseline deficits that we are projecting of $176 billion in 1989 and $167 billion in 1990 are well above the Balanced Budget Reaffirmation Act targets, which are $136 billion and $100 billion. The amount of deficit reduction required in 1989 under that Act is limited to $36 billion. Implementing the rest of the budget summit in 1989 would produce some additional savings from our projected baseline for that year. Specifically, it would produce about $3 billion in additional outlay reductions in discretionary appropriations from the 1989 baseline by adhering to the caps for appropriations in the summit agreement, while $0.4 billion in additional revenues would be generated from further increases in IRS enforcement resources.

The reason this occurs is that our baseline has more growth in it for inflation than is contemplated by the summit agreement. On average, these discretionary appropriations increases by 5 percent for inflation and pay in our baseline, whereas the summit agreement contemplated an increase of only about 2 percent for discretionary appropriations.

That is why, measured from our baseline, sticking to the appropriation caps in the summit agreement would produce additional saving of about $3 billion. Another way of thinking about it is that a lot of the savings that were contemplated for 1989 have already been accomplished by the actions the Congress took in December.

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[1] See p. 17.

But, even with these further savings, another $32 billion in deficit reduction would still be required, according to CBO estimates under the Balanced Budget Reaffirmation Act. The budget summit contemplated asset sales of another $3.5 billion, but these cannot be counted as savings against the Gramm-Rudman-Hollings targets under the terms of that Act.

If the Office of Management and Budget comes up with a similar estimate this summer, we calculate that missing the deficit target would require roughly 9 percent in across-the-board cuts in defense programs and 13 percent in nondefense programs, from their baseline levels. The reduction for defense could be much larger if the President exempted military personnel, as he did last year, and also in 1986.

These sequestration cuts could be avoided if OMB's estimate of the deficit were within $10 billion of the target—that is, less than $146 billion for 1989. While using more favorable economic assumptions could reduce the projected deficit to that level, relying on this approach to get through the 1989 budget year could make the 1990 deficit reduction task that much harder. Taking no action this year beyond that required by the budget summit would leave the 1990 deficit at about $160 billion, according to CBO's current estimates. With a 1990 deficit target of $100 billion, the excess deficit would be $60 billion, almost double the amount of deficit reduction achieved in the first year of the summit.

Let me turn now to the CBO's economic forecast for the next 2 years.

Just as the budget summit agreement for 1988 and 1989 was prompted by the stock market collapse of October 19th, so will budgetary developments for 1988 and 1989 be driven by the economic aftermath of this crash. The drop in share values wiped out hundreds of billions of dollars of consumer wealth and, as measured by the most widely watched indexes of consumer sentiment, weakened confidence in the prospects for the economy. Excluding automobiles, real personal consumption fell at a 1 percent rate in the fourth quarter of 1987, the first decline since 1981.

As a result of the weakness in consumption, businesses piled up unsold inventories throughout 1987, but especially in the fourth quarter. CBO expects that the attempt to reduce inventory accumulation will act as drag on the economy in early 1988. Real Federal purchases of goods and services are also expected to fall, reflecting successive years of budgetary stringency.

Some brighter signs, however, suggest that the economy will avoid a recession. Real net exports have started to improve as a result of 3 years of dollar depreciation, and net exports are likely to be the major engine of growth in the next 2 years. Because the saving rate has already increased substantially, further declines in consumption are not anticipated.

The financial crisis was the impetus for a major shift in monetary policy. From the Louvre accord in February 1987 through October, the Federal Reserve's stated aims were to support the value of the dollar and to dampen inflationary expectations. In pursuing these aims, the Federal Reserve was forced to keep up interest rates. After the crash, however, it permitted interest rates to fall, even at the cost of a depreciating dollar. This situation is likely to create inflationary pressures by the end of 1988 that will cause the central bank to shift back to a less accommodating stance.

CBO's short-run economic forecast for 1988 and 1989 is shown in table 2.[1] In addition to the monetary policy just described, the forecast assumes that the Federal fiscal policies are consistent with CBO's baseline revenue and outlay projections. The immediate outlook for the economy is substantially weaker than CBO expected in August. With a sluggish first half, real gross national product is expected to grow by only 1.8 percent in 1988, and this is measured on a fourth quarter to fourth quarter basis. The unemployment rate is expected to average 6.2 percent for 1988 as a whole, the same as for the previous year.

In 1989, growth is expected to return to a 2.6 percent rate, roughly the same as that assumed last year in CBO's summer projections, and only slightly lower than has occurred in the last 3 years. Unemployment should drop back slightly. Consumer price inflation, which totaled 4.4 percent in 1987, is expected to reach 4.9 percent in 1988, and 4.8 percent in 1989. This again is measured on a fourth quarter to fourth quarter basis. The GNP deflator is expected to increase more slowly than the Consumer Price Index, since the step-up in inflation is driven mainly by import prices, which do not add to the GNP deflator.

As a result of the slow real growth and the Federal Reserve's accommodative stance in the first half of 1988, there should be little immediate pressure on interest rates. Later in the year, however, the 3-month Treasury bill rate should begin to rise in response to the projected higher inflation rate. For the year as a whole, CBO projects that the bill rate will average 6.2 percent. Ten-year Government note yields will rise even more sharply, averaging 9.3 percent for the year, as they incorporate expectations of still greater inflation in the future resulting from the accommodative monetary policy. In 1989, the resumption of growth and the Federal Reserve's anticipated tightening will cause short-term real interest rates to continue rising. Long-term rates in 1989, however, are projected to be relatively flat.

This outlook for the economy depends on the success of the Federal Reserve in supplying the economy with enough credit to avoid a recession, without reigniting inflation or undermining the dollar. It also assumes that the long-awaited improvement in net exports has finally arrived and will accelerate in 1988. On the other hand, the economy could prove stronger than CBO forecasts if we have overestimated the extent of consumer retrenchment. These are some of the major uncertainties that underlie the CBO forecast.

The CBO forecast sees less rapid real growth and higher interest rates during the next 2 years than does the administration. This, too, is shown in table 2. Compared with private sector forecasters, however, the CBO's growth forecast is about average for 1988, and is actually above the average for 1989. CBO's interest rates are slightly above the consensus, as a result both of stronger 1989 growth and the continued fall in the dollar.

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[1] See p. 21.

While we do not have all of the details of the administration's forecast, it appears that using their economic assumptions would lower the 1989 baseline deficit by about $25 billion to $30 billion. The differences between the CBO and the consensus forecasts, however, are sufficiently small that they would have little effect on our budget estimates.

Beyond 1989, CBO's economic assumptions are not a forecast of future conditions, but are projections based on historical trends. The projections do not include business cycles. They assume that the economy's long-term growth depends largely on the growth of the labor force, and that output per worker will grow at about the same rate it has in recent years.

CBO's 5-year economic projections and the corresponding baseline budget projections are presented in table 3[1] and they are illustrated graphically in Figure 2.[2]

In the projections, real GNP growth is at an annual average rate of about 2.7 percent from 1989 to 1993, while the civilian unemployment rate falls to about 5.8 percent. As measured by the GNP deflator, an inflation stays at 4 percent or close to the postwar average. Consumer price inflation is slightly higher, however, because of further declines in the dollar and increases in import prices over the medium turn.

After 1989, real interest rates decline to levels consistent with their average since exchange rates began floating in 1971. I think it is important to note that cyclical changes will presumably affect the level of activity during the projection years, but there is no way of predicting when they will occur or what will precipitate them. Therefore, the projections should be thought of as an average of a number of possible paths for the economy in the longer run.

In any event, under these longer run assumptions, the baseline deficit is projected to decline slowly from $176 billion in 1989 to $131 billion in 1993. The deficit shrinks because revenues are boosted by both inflation and real growth, while outlays rise only slightly faster than the rate of inflation. Compared with the size of the nation's economy, the baseline deficit falls from 3.1 percent of GNP in 1990 to 2.1 percent in 1993.

In our new report, we have attempted to quantify the uncertainty inherent in these long-run economic and budget projections, the uncertainty Senator Domenici referred to.

The approach we use is an extension of our analysis in last summer's report, and is largely statistical in nature. We find that there are about two chances in three that the level of real GNP in 1993 will turn out to be within 7 percent of its projected value, or that the average real growth rate between 1987 and 1993 will be between 1.6 percent and 3.6 percent. As a result, there is a two-in-three chance that the 1993 deficit will be within $125 billion of its projected value of $134 billion. This large degree of uncertainty illustrates the point made earlier that the longer run projections should be viewed only as a general indicator of budgetary trends and not as a forecast of future budgets.

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[1] See p. 24.

[2] See p. 26.

Mr. Chairman, that concludes my formal statement.

[The prepared statement of James L. Blum follows:]

Statement of
James L. Blum
Acting Director and
Assistant Director for Budget Analysis
Congressional Budget Office

before the
Committee on the Budget
United States Senate

February 4, 1988

Mr. Chairman, I am pleased to appear before this Committee to discuss the economic and budget projections of the Congressional Budget Office (CBO). These projections will be described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1989-1993*, which we plan to release on Thursday, February 11.

In the closing days of 1987, the Congress and the Administration negotiated and largely put in place a plan to reduce the budget deficit for 1988 and 1989. At the same time, in the wake of the stock market collapse, signs of some temporary weakness in the economy began to emerge. The Congressional Budget Office now anticipates that the economy will experience a pronounced slowdown in growth in early 1988, but will regain strength in the second half of 1988 and in 1989. On the basis of CBO's economic assumptions and a continuation of current budgetary policies, the federal deficit is projected to rise from $149 billion in 1987 to $157 billion in 1988 and $176 billion in 1989, before dropping to $167 billion in 1990.

These baseline budget projections assume that revenues, offsetting receipts, and entitlement spending are projected according to the laws now on the statute books. Defense and nondefense discretionary appropriations are assumed to be held constant in real terms. The baseline projections are, therefore, not forecasts of future budgets, which will doubtless include numerous policy changes. This year CBO has made minor changes in its baseline to make it identical to the budget base as specified in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 (P.L. 100-119). We hope that having a single baseline will help focus attention on the fundamentals of the budget situation and reduce any confusion stemming from minor conceptual differences.

THE SHORT-RUN BUDGET SITUATION

On November 16, as required by the Balanced Budget Reaffirmation Act of 1987, CBO reported that the budget deficit for 1988 would be $180 billion under laws then in effect. It also projected a deficit of $186 billion in 1989 and $166 billion in 1990. These estimates were based on CBO's August economic and technical estimating assumptions. How have the budget estimates changed since November?

On November 20, Congressional leaders and the President announced that they had reached a budget agreement covering the next two fiscal years. This agreement, or budget summit, was intended to reduce the deficit by $30 billion in 1988 and $46 billion in 1989 from the Balanced Budget Act baseline. The results of the budget summit were almost entirely incorporated in two bills--the continuing resolution of appropriations (P.L. 100-202) and the Omnibus Budget Reconciliation

Act of 1987 (P.L. 100-203)--signed by the President on December 22. These laws reduced the 1988 deficit by an estimated $34 billion, comprising $23 billion in lower spending and $11 billion in additional revenues. The projected deficit reduction will then swell to $36 billion in 1989 and $40 billion in 1990, assuming that spending programs subject to annual appropriation action are allowed to grow by only the rate of inflation (see Table 1).

TABLE 1. BASELINE DEFICIT PROJECTIONS FOR 1988-1990
(By fiscal year)

	Actual		Projections		
	1986	1987	1988	1989	1990
	In Billions of Dollars				
November 1987 Base Deficit for Balanced Budget Act	221	149	180	186	166
Changes for:					
Enacted legislation	--	--	-34	-36	-40
Updated economic assumptions	--	--	9	21	33
Technical reestimates	--	--	2	6	8
Total changes	--	--	-23	-10	1
February 1988 Baseline Deficit	221	149	157	176	167
Adjustments for:					
Tax reform	--	22	-10	-16	-4
One-time outlay savings	2	15	6	-3	-3
Total adjustments	2	37	-5	-19	-7
Adjusted Deficit	223	186	152	156	160
	As a Percentage of GNP				
Baseline Deficit	5.3	3.4	3.4	3.5	3.1
Adjusted Deficit	5.4	4.2	3.3	3.1	3.0

SOURCE: Congressional Budget Office.

While policymakers were working hard to reduce the deficit, however, a deterioration in the economic outlook was eroding some of their improvements. CBO's updated economic assumptions add $9 billion to the deficit in 1988, $21 billion in 1989, and $33 billion in 1990, compared with the November estimates. In 1988 and 1989, most of these changes result from lower tax revenues brought on by the forecast of a slowdown in economic growth. By 1990, however, the primary factor is a projected increase in interest rates, which adds to the costs of servicing the national debt.

Changes in technical estimating methods and assumptions have increased the projected deficit slightly--by $2 billion in 1988, $6 billion in 1989, and $8 billion in 1990--since CBO's November report. These reestimates result primarily from newly available data that permit a better estimate of the effects of the Tax Reform Act of 1986 (P.L. 99-514). Technical revisions in outlay estimates, while large for some individual programs, are negligible in total in most years.

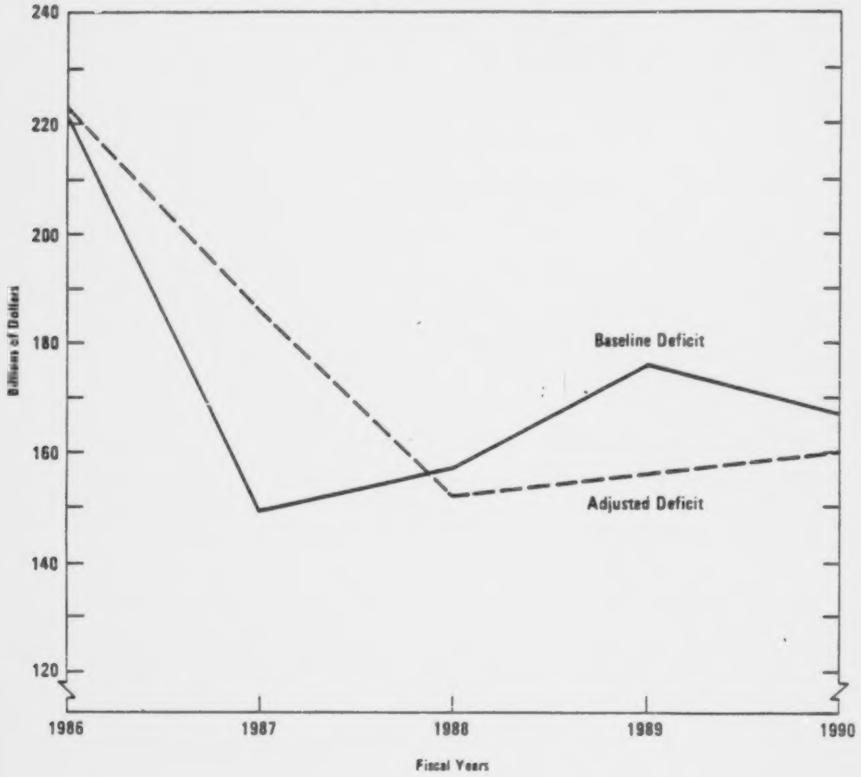
The recent policy actions and economic and technical reestimates have not changed the pattern of the deficit: it fell sharply in 1987, will rise in 1988 and 1989, and will fall again in 1990. This jagged shape is largely the result of the phase-in of the Tax Reform Act of 1986 and of various one-time outlay savings. Tax reform added $22 billion to revenues in 1987 but reduces tax collections by $10 billion in 1988 and

$16 billion in 1989. Asset sales and other one-time spending cuts hold down outlays by $15 billion in 1987 and $6 billion in 1988. The 1988 savings result from loan prepayments permitted by the recent appropriation and reconciliation bills. Were it not for these special factors, the pattern of the deficits would be much smoother, as shown in Figure 1. The deficit would have fallen less sharply in 1987--to about $186 billion--and would then fall further to the range of $150 billion to $160 billion, where it would remain for several years.

The baseline deficits of $176 billion in 1989 and $167 billion in 1990 are well above the Balanced Budget Reaffirmation Act targets of $136 billion and $100 billion. The amount of deficit reduction required in 1989 is limited by law to $36 billion. Implementing the rest of the budget summit in 1989 would produce about $3 billion in additional outlay reductions in discretionary appropriations from the 1989 baseline and $0.4 billion in additional revenues resulting from further increases in IRS enforcement resources. But even with these further savings, another $32 billion in deficit reduction would still be required. (Asset sales of $3.5 billion, although required by the budget summit, may not be counted as savings under the terms of the Balanced Budget Reaffirmation Act.) If the Office of Management and Budget (OMB) comes up with similar estimates this summer, across-the-board cuts would be required of roughly 9 percent in defense programs and 13 percent in nondefense programs from their baseline levels.

Figure 1.

Deficit Adjusted for Tax Reform Act and One-Time Savings



SOURCE: Congressional Budget Office.

These cuts could be avoided if OMB's estimate of the deficit were within $10 billion of the target--that is, less than $146 billion. While using more favorable economic assumptions could reduce the projected deficit to that level, relying on this approach to get through the 1989 budget year would make the 1990 deficit reduction task that much harder. Taking no action this year beyond that required by the budget summit would leave the 1990 deficit around $160 billion, according to CBO's current estimates. With a 1990 deficit target of $100 billion, the excess deficit would be $60 billion, almost double the amount of deficit reduction achieved in the first year of the summit.

THE SHORT-TERM ECONOMIC OUTLOOK

Just as the budget summit agreement for 1988 and 1989 was prompted by the stock market collapse of October 19, so will budgetary developments for 1988 and 1989 be driven by the economic aftermath of the crash. The drop in share values wiped out hundreds of billions of dollars of consumer wealth and, as measured by the most widely watched indexes of consumer sentiment, weakened confidence in the prospects for the economy. Excluding automobiles, real personal consumption fell at a 1 percent rate in the fourth quarter of 1987--the first decline since 1981.

As a result of the weakness in consumption, business piled up unsold inventories throughout 1987, but especially in the fourth quarter. CBO expects that the attempt to reduce inventory accumulation will act as a drag on the economy in early 1988. Real federal purchases of goods and services are also expected to fall, reflecting successive years of budgetary stringency.

Some brighter signs, however, suggest that the economy will avoid a recession. Real net exports have started to improve as a result of three years of dollar depreciation, and net exports are likely to be the major engine of growth in 1988 and 1989. Because the saving rate has already increased substantially, further declines in consumption are not anticipated.

The financial crisis was the impetus for a major shift in monetary policy. From the Louvre accord in February 1987 through October, the Federal Reserve's stated aims were to support the value of the dollar and to dampen inflationary expectations. In pursuing these aims, the Federal Reserve was forced to keep up interest rates. After the crash, however, it permitted interest rates to fall even at the cost of a depreciating dollar. This situation is likely to create inflationary pressures by the end of 1988 that will cause the central bank to shift back to a less accommodating stance.

CBO's short-run economic forecast for 1988 and 1989 is shown in Table 2. In addition to the monetary policy just described, the forecast assumes that federal fiscal policies are consistent with CBO's baseline revenue and outlay projections. The immediate outlook for the economy is substantially weaker than CBO expected in August. With a sluggish first half, real gross national product (GNP) is expected to grow by only 1.8 percent in 1988 (measured from fourth quarter to fourth quarter). The unemployment rate will average 6.2 percent for 1988 as a whole, the same as the previous year. In 1989, growth is expected to return to a 2.6 percent rate, roughly the same as that assumed in CBO's summer projections and only slightly lower than in the last three years, and unemployment should drop back. Consumer price inflation, which totaled 4.4 percent in 1987, is expected to reach 4.9 percent in 1988 and 4.8 percent in 1989. The GNP deflator is expected to increase more slowly than the Consumer Price Index, since the step-up in inflation is driven mainly by import prices, which do not add to the GNP deflator.

TABLE 2. CBO, ADMINISTRATION AND CONSENSUS FORECASTS FOR 1988 AND 1989 (By calendar year)

	Actual	Forecast	
	1987	1988	1989
Fourth Quarter to Fourth Quarter (Percent change)			
Real Gross National Product			
CBO	3.8	1.8	2.6
Administration	3.8	2.4	3.5
Consensus	3.8	1.8	2.0
GNP Deflator			
CBO	3.3	3.9	4.2
Administration	3.3	3.9	3.7
Consensus	3.3	3.8	4.3
Consumer Price Index (CPI-U)			
CBO	4.4	4.9	4.8
Administration	4.4	4.3	3.9
Consensus	4.4	4.2	4.8
Calendar-Year Average (Percent)			
Three-Month Treasury Bill Rate			
CBO	5.8	6.2	6.7
Administration	5.8	5.3	5.2
Consensus	5.8	6.0	6.5
Ten-Year Government Note Rate			
CBO	8.4	9.3	9.5
Administration	8.4	8.0	7.4
Consensus a/	8.4	9.0	9.1
Civilian Unemployment Rate			
CBO	6.2	6.2	6.1
Administration b/	6.1	5.8	5.6
Consensus	6.2	6.2	6.3

SOURCE: Congressional Budget Office, February 1988 economic forecast; Council of Economic Advisers press release, December 23, 1987; Blue Chip Economic Indicators, January 10, 1988 (revised).

a. Averages are calculated by using CBO's projection of the difference between the corporate bond rate and the 10-year government note rate.

b. The Administration's projection is for the total labor force, including armed forces residing in the United States. In recent years, this rate has tended to be 0.1 to 0.2 percentage points below the civilian unemployment rate.

As a result of the slow real growth and the Federal Reserve's accommodative stance in the first half of 1988, there will be little immediate pressure on interest rates. Later in the year, the three-month Treasury bill rate should begin to rise in response to the higher inflation rate. For the year as a whole, CBO projects that the bill rate will average 6.2 percent. Ten-year government note yields will rise even more sharply, averaging 9.3 percent for the year, as they incorporate expectations of still greater inflation in the future resulting from the accommodative monetary policy. In 1989, the resumption of growth and the Federal Reserve's anticipated tightening will cause short-term real interest rates to continue rising. Long-term rates in 1989, however, are projected to be relatively flat.

This outlook for the economy depends on the success of the Federal Reserve in supplying the economy with enough credit to avoid a recession, without reigniting inflation or undermining the dollar. It also assumes that the long-awaited improvement in net exports has finally arrived and will accelerate in 1988. On the other hand, the economy could prove stronger than CBO forecasts if we have overestimated the extent of consumer retrenchment.

CBO foresees less rapid real growth and higher interest rates during the next two years than does the Administration, as shown in Table 2. Compared with private-sector forecasters, however, CBO's growth forecast is about average for 1988 and is actually above the average for 1989. CBO's interest rates are slightly above the consensus, as a result both of stronger 1989 growth and the continued fall of the dollar. While we do not have all the details of the Administration's forecast, it appears that using their economic assumptions would lower the 1989 baseline deficit by about $25 billion to $30 billion. The differences between the CBO and consensus forecasts, however, are sufficiently small that they would have little effect on the budget estimates.

LONGER-RUN BASELINE PROJECTIONS

Beyond 1989, CBO's economic assumptions are not a forecast of future conditions but are projections based on historical trends. The projections do not include business cycles. They assume that the economy's long-term growth depends largely on the growth of the labor force and that output per worker will grow at about the same rate it has in recent years. CBO's five-year economic projections and the corresponding baseline budget projections are presented in Table 3.

In the projections, real GNP grows at an average annual rate of about 2.7 percent from 1989 to 1993, while the civilian unemployment

TABLE 3. BASELINE BUDGET PROJECTIONS AND UNDERLYING ASSUMPTIONS

	Actual 1987	1988	1989	1990	1991	1992	1993
	Budget Projections (By fiscal year, in billions of dollars) a/						
Revenues	854	897	953	1,036	1,112	1,181	1,262
Outlays	1,003	1,055	1,129	1,203	1,270	1,332	1,396
Deficit	149	157	176	167	158	151	134
	Economic Assumptions (By calendar year)						
Nominal GNP Growth (percent change)	5.9	5.8	6.8	6.8	6.8	6.9	6.9
Real GNP Growth (percent change)	2.9	2.3	2.6	2.6	2.6	2.7	2.7
Implicit GNP Deflator (percent change)	3.0	3.4	4.1	4.1	4.1	4.1	4.1
CPI-W b/ (percent change)	3.6	4.5	4.9	4.6	4.4	4.4	4.4
Civilian Unemployment Rate (percent)	6.2	6.2	6.1	6.0	5.9	5.9	5.8
Three-Month Treasury Bill Rate (percent)	5.8	6.2	6.7	6.6	6.4	6.1	5.9
Ten-Year Government Note Rate (percent)	8.4	9.3	9.5	9.0	8.4	7.8	7.4

SOURCE: Congressional Budget Office.

a. The baseline estimates include Social Security, which is off-budget.

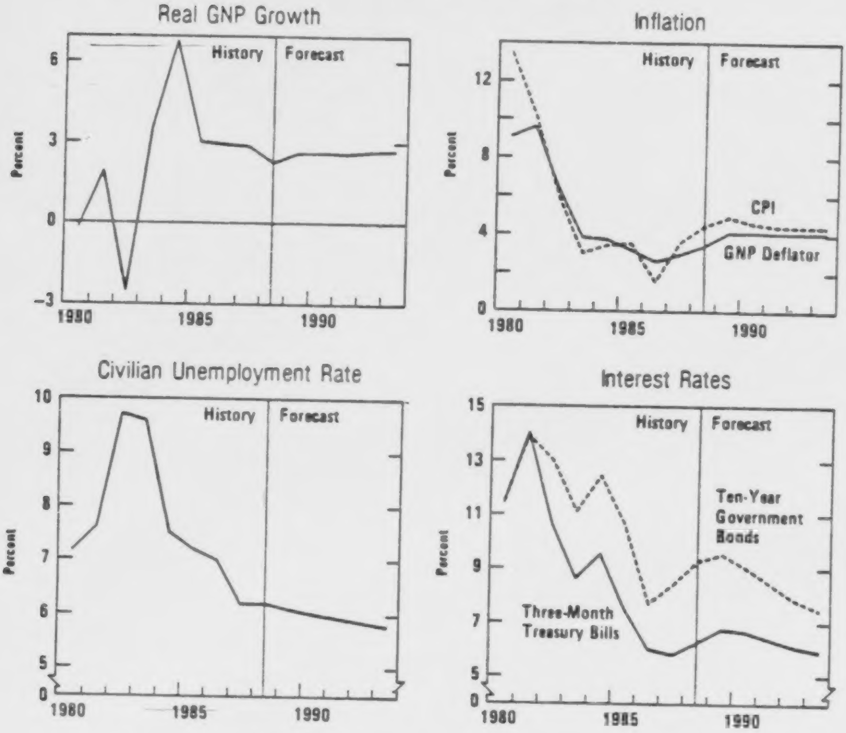
b. Consumer Price Index for urban wage earners and clerical workers.

rate falls to about 5.8 percent (see Figure 2). As measured by the GNP deflator, inflation stays at 4 percent, close to the postwar average. Consumer price inflation is slightly higher, however, because of further declines in the dollar and increases in import prices over the medium term. After 1989, real interest rates decline to levels consistent with their average since exchange rates began floating in 1971.

In such an environment of continued real economic growth, the baseline deficit is projected to decline slowly from $176 billion in 1989 to $134 billion in 1993. The deficit shrinks because revenues are boosted by both inflation and real growth, while outlays rise only slightly faster than the rate of inflation. Compared with the size of the nation's economy, the baseline deficit falls from 3.1 percent of the gross national product in 1990 to 2.1 percent in 1993.

In our new report, we have attempted to quantify the uncertainty inherent in these long-term economic and budget projections. The approach we used is an extension of our analysis in last summer's report of the accuracy of budget-year estimates. We find that there are about two chances in three that the level of real GNP in 1993 will turn out to be within 7 percent of its projected value, or that the average real growth rate between 1987 and 1993 will be between 1.6 percent and 3.6 percent. As a result, there is a two-in-three chance that the 1993 deficit will be within $125 billion of its projected value of $134 billion.

Figure 2.
Major Economic Assumptions


Real GNP Growth

Inflation

Civilian Unemployment Rate

Interest Rates

SOURCES Congressional Budget Office, Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

This large degree of uncertainty illustrates the point made earlier that the longer-run projections should be viewed only as a general indicator of budgetary trends and not as a forecast of future budgets.

With your permission, I would like to ask two of my colleagues to join me at the table to assist me in responding to your questions.

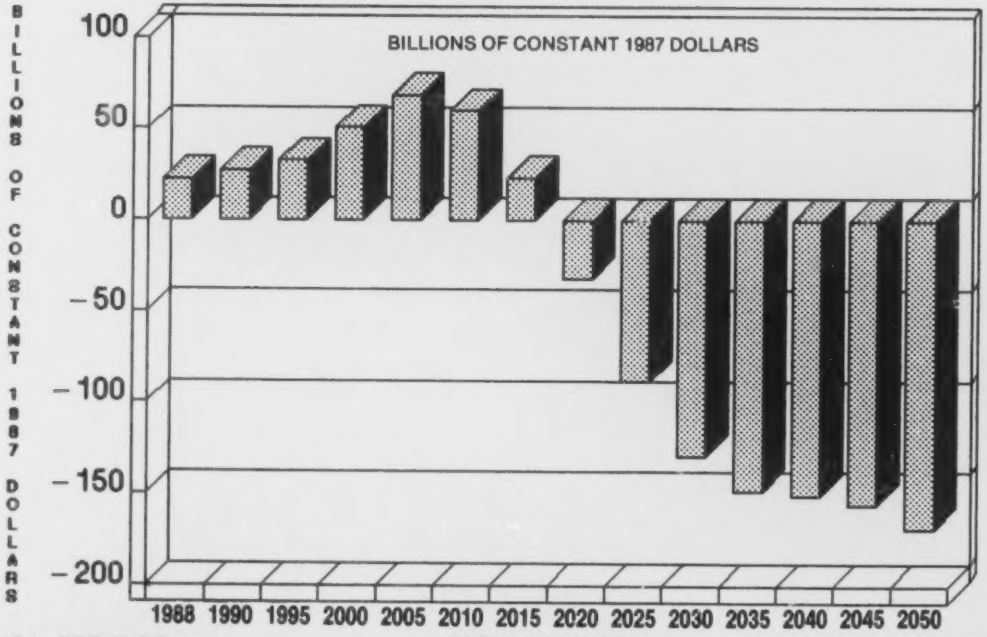
Chairman CHILES. We would be happy to have them. Would you introduce them first?

Mr. BLUM. Yes, I will. Rosemary Marcuss is our Assistant Director for the Tax Analysis Division, and Jacob Dreyer is the Acting Assistant Director for our Fiscal Analysis Division, and is responsible for putting together the details of our economic forecast.

Chairman CHILES. Mr. Blum, on the face of it, one would think that the slight down trend in the Federal deficit expected in the out years is cause for perhaps a little hope that we have begun to restore some control in fiscal policy. More careful analysis, however, shows just how formidable the deficit foe remains.

The magnitude of the crisis is most definite when we look at the on-budget deficit, that is, the size of the Federal deficit if we do not count the growing social security surplus. Referring to the chart I have up there, Mr. Blum, could you give us CBO's estimate of the social security surplus in 1988?

SOCIAL SECURITY ANNUAL BALANCE: FROM SURPLUS TO DEFICIT



Data: CRS & Office of
Social Security Actuary

SBC Staff
Feb. 4, 1988

Mr. BLUM. As shown in the chart, Mr. Chairman, our estimate is that the surplus in the social security trust funds will be about $37 billion in 1988, and that——

Chairman CHILES. What then is the on-budget deficit, that is, the deficit in the Federal budget other than social security?

Mr. BLUM. That $37 billion would have to be added to our $157 billion deficit for——

Chairman CHILES. So you get $195 billion?

Mr. BLUM. So we get to $195 billion.

Chairman CHILES. The on-budget deficit is nearly $200 billion in 1988.

Mr. BLUM. That is correct.

Chairman CHILES. What happens to the on-budget deficit and the annual social security balance by 1993?

Mr. BLUM. As the chart amply illustrates, the surpluses in the trust funds are expected to grow from $37 billion to $97 billion during this period, a growth of $60 billion, and the on-budget deficit also grows from $195 billion to $231 billion by 1993.

Chairman CHILES. In other words, CBO expects the on-budget deficit in the neighborhood of $230 billion through the duration of your forecast even though you expect some small decrease in the total Federal deficit?

Mr. BLUM. That is correct, Mr. Chairman. It is not quite that high in the near-term, but it does grow to that amount, by the last couple of years of that period.

Chairman CHILES. The alarming size of the on-budget deficit I think is the paramount long-term budgetary issue Congress and the President must face. Moreover, the social security surplus is a emporary phenomena. The U.S. Government will need to meet social security obligations in the twenty-first century and those surpluses will disappear and become deficits.

The annual surpluses turn to annual deficits when the baby boom generations start retiring, as seen in this accompanying chart.[1] The chart shows that social security will be running an annual deficit beginning around the year 2015, and that such deficits will continue indefinitely. In view of that fact, what consequences would result if we eliminate the surplus before the baby boomers retire?

Mr. BLUM. One important point to note, Mr. Chairman, is that eliminating the surplus in the shortrun actually makes the Federal deficit as a whole that much larger. As a policy, that could make it more difficult to have enough saving for investment purposes so as to generate the economic growth necessary to fund private retirement plans as well as social security.

Chairman CHILES. Therefore, it would be a wise policy to focus on eliminating the on-budget deficits to effectively save the social security surplus to help out after the year 2015, would it not?

Mr. BLUM. Well, I think reducing the Federal deficits, or the dissaving that the Federal Government is doing, would enable a productive use of the funds for economic growth, and any move in that direction I think would be good.

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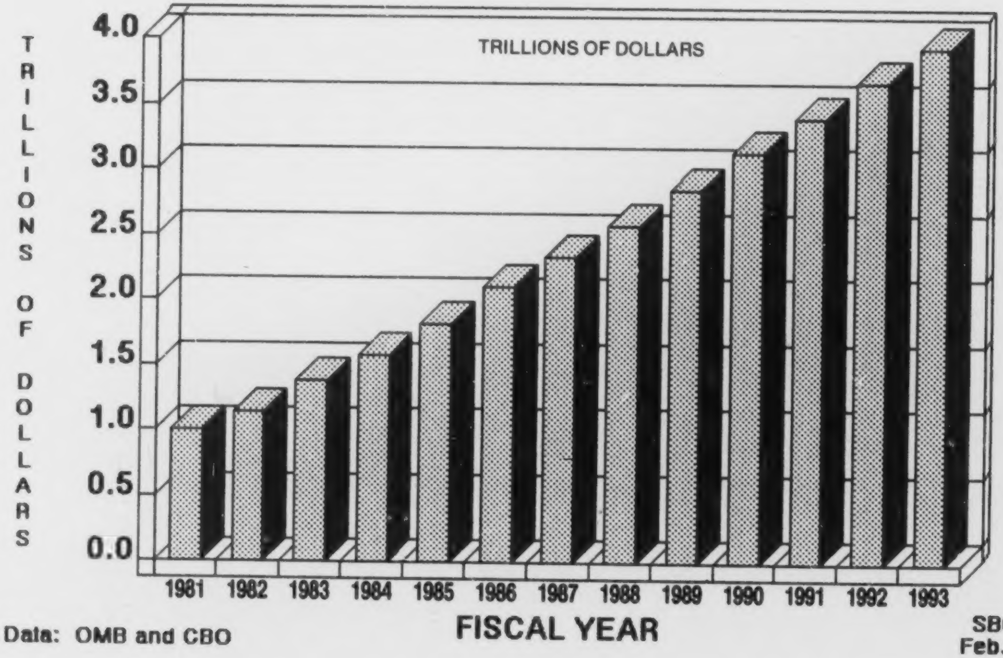
[1] See p. 32.

Chairman CHILES. We have a chart that illustrates the unprecedented accumulation of Federal debt in the 1980s. This chart also shows CBO's projections of how the national debt will continue to grow through 1993, covering the entire period of the forecast. Would you walk us through the table, starting in 1980, and describe where we are today and where we expect to be in 1993?

QUADRUPLING OF THE FEDERAL DEBT

1981 – 1993



Data: OMB and CBO

SBC staff
Feb. 4, 1988

Mr. BLUM. Yes, Mr. Chairman. The chart is showing the growth in debt subject to the statutory limit. This is the limit that the Congress had to vote on from time to time. As you recall, the last vote put the debt limit at $2.8 trillion, which is expected to carry us into the early part of next year. The chart shows us that, in 1981, debt subject to the limit stood at about a trillion dollars, while now at the end of 1987 it has grown to $2.3 trillion, and projected under our baseline, assumptions it will grow to about $4 trillion by 1993.

Now, I should point out, Mr. Chairman, that another measure of Federal debt—one which gets particular attention from the economic and financial analysts—is debt held by the public. The debt subject to statutory limit also includes the investments in government securities by the social security trust funds and other government bodies, which are largely intergovernmental transactions. But debt held by the public, which is thought to be a very key indicator, is also growing.

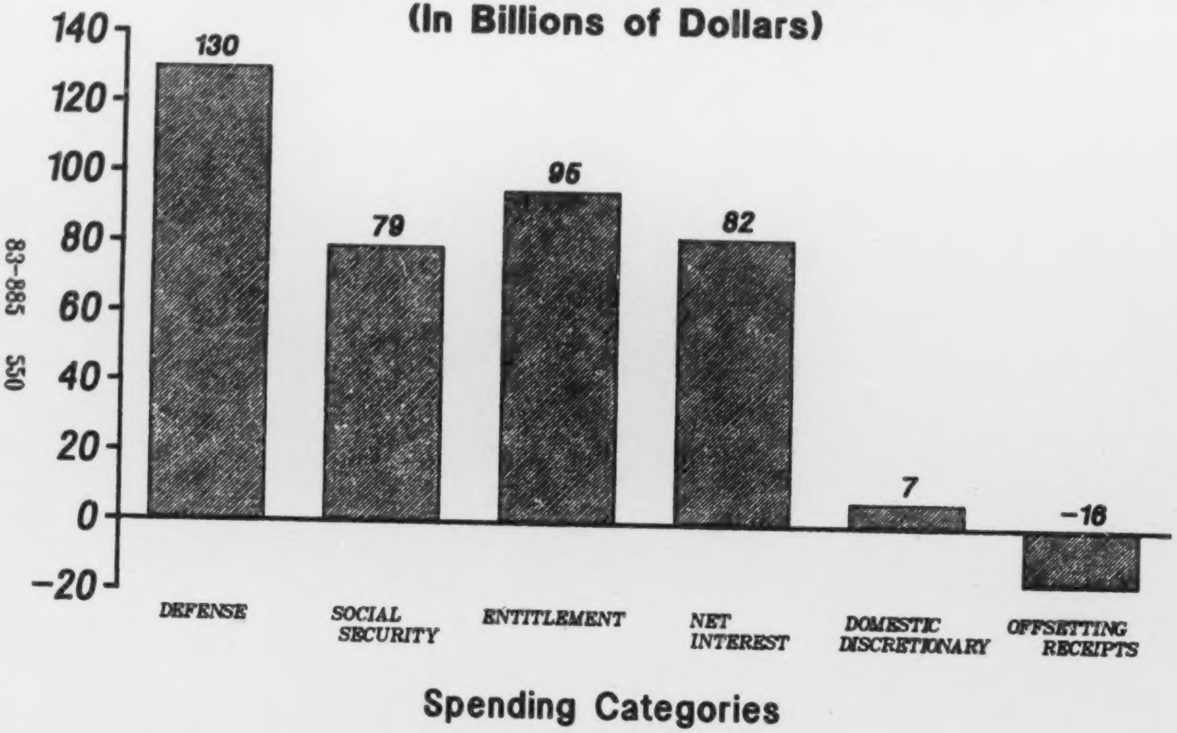
It rose in 1981, for example, to about a level of $800 million then up to $1.9 trillion by the end of 1987, and under our projections would grow almost another trillion dollars by the end of 1993. Relative to the economy, however, the picture is slightly different.

Debt held by the public as a percentage of GNP rises from about 27 percent in 1981 to 43 percent at the end of 1987, but after that it only grows a little bit, and actually peaks during the next 5 years and then essentially be held flat.

Chairman CHILES. Mr. Blum, we have prepared a chart using the CBO data which shows the changes in Federal spending priorities since 1981. Federal outlays increased by $377 billion from 1981 to 1988. It is interesting to examine the sources of the increase.

THE $377 BILLION INCREASE IN FEDERAL OUTLAYS SINCE 1981

(In Billions of Dollars)



Prepared by Senate Budget Committee Staff – Feb. 4, 1988

Referring to this chart, Mr. Blum, would you describe for us the changes in Federal spending priorities since 1980?

Mr. BLUM. Yes, sir, Mr. Chairman. This chart explains the nominal dollar increase between 1981 and our estimates for 1988, using the categories of spending in our report. It shows that the largest dollar increase, $130 billion, is for national defense. We also looked at defense spending relative to GNP and it grew 0.8 percentage points, a very large growth.

Social security benefits grew from $79 billion, and other entitlements increased by $95 billion. But relative to the growth in GNP, these stayed about even.

In relative terms, the fastest growing area of the budget during this period of time was net interest payments. Here the nominal dollar increase was $82 billion, but as a percentage of GNP the growth was 0.9 percentage points.

Now, the big loser——

Chairman CHILES. That is a number that can really haunt us if we did nothing about that 1993 deficit going to almost $4 trillion, is it not?

Mr. BLUM. That is right; it becomes very expensive to service the debt. The big loser depicted on this chart is nondefense discretionary spending, which grew about $7 billion. Relative to GNP, however, it shrank by 2 percentage points.

Chairman CHILES. And then, offsetting receipts were actually——

Mr. BLUM. Offsetting receipts show as a minus. Actually, they increase because they are minus——

Chairman CHILES. That means that we got additional revenue of $16 billion.

Mr. BLUM. That is right. Another way of looking at these categories is in terms of real growth. Again, interest comes out highest, the nominal percentage increase in interest is 120 percent over this period of time. In real terms, that is about a 67-percent increase. The next largest relative increase is in national defense, which grew 82 percent in nominal terms but in real terms about 40 percent.

Social security benefits and other entitlements also grew at about the same rate as the budget as a whole.

Chairman CHILES. Senator Domenici?

Senator DOMENICI. Mr. Chairman, I wanted to just ask you and the other members, if I might speak soon. I personally can stay here until about 25 after. If somebody else is on a short time frame, I would yield now as long as I get 10 minutes after that.

Senator Grassley, are you in a rush? If you are, I will yield. We have been going on now for 5 minutes each. Would you like to proceed?

Senator GRASSLEY. Yes, if I could.

Senator DOMENICI. I know we are going to go to your side, but as long as I get a few minutes as you had, I will yield to Senator Grassley at this point.

Senator GRASSLEY. I have a combination of questions as well as statements that I want to make, Mr. Blum. First of all, prior to the fiscal year 1989 budget resolution, the CBO projected a baseline deficit of $169 billion, and then we cut $36 billion from that baseline last year in the first budget resolution, and then the facts are as you have given them 1 year later were somehow still at $166 billion for the 1988 deficit—no, that is not according to you, but according to the blue chip consensus financial forecasts of February lst, and according to GBO it will be $157 billion.

So, a year ago we thought we were cutting $36 billion out of the deficit, when in fact we will probably be lucky if we are somewhere between zero and $10 billion lower, compared to last year's baseline, but that was last year.

In the years before that, I think it fair to say that similar misestimates occurred except for one instance, 1980, and the question that is kind of on the table, because it has been discussed in the press and has been discussed among some of our colleagues now, is whether or not all of a sudden the CBO might be shifting from a forecast of optimism to one of pessimism.

So, let me ask you, did CBO make any substantial changes this year in its methodology of forecasting economics or the deficits that might make your 1989 projections more pessimistic or even more optimistic than usual?

Mr. BLUM. No, I do not think so, Senator. We have proceeded with the same deliberate methods of forecasting the economy that we have used in the past. Essentially, it consists of a very careful reading of events as they have unfolded from the time we last made an economic forecast. We also have a very distinguished group of economic advisers whom we consult before presenting the forecasts. I think it is fair to characterize our forecasts as being relatively close to the consensus at the time we make them.

Senator GRASSLEY. So, CBO continues to adhere then to its traditional methodology, basically?

Mr. BLUM. That is right.

Senator GRASSLEY. OK. I have a chart. Although there is not anything new in this chart, I just want you to at least know what I am referring to here. I refer to the GNP part of it. It shows CBO's CNP projections as compared to other projections, and these are projections that are made at the beginning of the budget process for the following fiscal year's budget.

TABLE III-5. BUDGET YEAR GNP FORECASTS AND ERRORS (By fiscal year)

Fiscal Year	Actual a/	CBO	OMB	CHASE	DRI	WEFA	Mechanical b/
			Forecasts in Billions of Current Dollars				
1978	2,044.8	1,987.0	2,038.4	1,953.2	2,011.1	2,030.2	1,956.1
1979	2,313.1	2,247.9	2,274.6	2,222.7	2,245.8	2,270.4	2,238.4
1980	2,521.4	2,515.1	2,505.7	2,436.6	2,475.7	2,460.6	2,538.6
1981	2,856.5	2,767.3	2,764.4	2,738.1	2,785.7	2,760.5	2,853.3
1982	3,031.2	3,211.1	3,191.8	3,220.0	3,204.9	3,232.4	3,167.4
1983	3,228.4	3,424.1	3,433.6	3,462.5	3,428.8	3,448.4	3,515.5
1984	3,581.2	3,498.8	3,488.7	3,532.7	3,509.3	3,530.5	3,501.9
1985	3,834.6	3,910.0	3,890.1	3,883.0	3,849.8	3,901.5	3,761.8
1986	4,163.4	4,158.2	4,198.5	4,139.7	4,086.1	4,150.4	4,212.3
1987	4,406.8	4,503.7	4,538.1	4,432.6	4,401.8	4,467.1	4,605.6
			Percentage Errors (Forecast Minus Actual as a Percent of Actual)				
1978		-2.8	-0.3	-4.5	-1.6	-0.7	-4.3
1979		-2.8	-1.7	-3.7	-2.9	-1.8	-3.2
1980		-0.2	-0.6	-3.4	-1.8	-2.4	0.7
1981		-3.1	-3.2	-4.1	-2.5	-3.4	-0.1
1982		5.9	5.3	6.2	5.7	6.6	4.5
1983		6.1	6.4	7.3	6.2	6.8	8.9
1984		-2.3	-2.6	-1.4	-2.0	-1.4	-2.2
1985		2.0	1.4	1.3	0.4	1.7	-1.9
1986		-0.1	0.8	-0.6	-1.9	-0.3	1.2
1987		2.2	3.0	0.6	-0.1	1.4	4.5
			Summary Statistics				
Mean Percentage Error							
1978-87		0.5	0.9	-0.2	c/	0.7	0.8
1980-87		1.3	1.3	0.7	0.5	1.1	1.9
Mean Absolute Percentage Error							
1978-87		2.8	2.5	3.3	2.5	2.7	3.2
1980-87		2.7	2.9	3.1	2.6	3.0	3.0

SOURCES. Forecasts are those for the budget year as constructed in late January of the previous calendar year. Forecast series for CBO and OMB were obtained from unpublished quarterly forecast tables. Other institutional forecasts were obtained from published reports. See Appendix A.

a. The actual series consists of the estimate published by the Commerce Department in the first November following the close of the respective fiscal year. For 1987, the latest available forecasts of CBO, OMB DRI, and WEFA were averaged.

b. This is the average of 42 univariate autoregressive forecasts. See Appendix A.

c. Less than 0.5 in absolute value.

The numbers show projections for each of the past 5 years for CBO, OMB, the consensus forecasts and then what actually occurs. Now, in most cases OMB is the most optimistic, the consensus is the most realistic, and the CBO comes somewhere in between.

I noticed in table 2 of your testimony that you are again forecasting for CBO a GNP forecast in between the consensus and OMB.

Mr. **Blum**. That certainly is the case for 1989.

Senator **Grassley**. So, at least in the GNP, is it fair to say that the CBO is neither more optimistic nor more pessimistic in this year's forecast as compared to other forecasts or with the historical norm?

Mr. **Blum**. I think that would be fair.

Senator **Grassley**. Last August, in CBO's update, there is an entire chapter based on an amendment that I was able to get adopted showing that the CBO since 1980 has underestimated the deficit on an average of $14 billion. This year's mis-estimate would be about $20 billion. The August report says that the biggest source of error has been inaccurate economic assumptions. More than 50 percent of the cause of mis-estimate was because of overestimation of the GNP. Much of that, maybe all of it, could be corrected by eliminating or reducing bias, and that is stated in the report as well.

What did CBO do since that report was issued to eliminate bias in its GNP estimates?

Mr. **Blum**. Well, I think bias is a very elusive concept to find in——

Senator **Grassley**. Can I suggest why I feel comfortable in using that word——

Mr. **Blum**. All right.

Senator **Grassley**. Because I think we have had dialogue on this between myself, some others on the committee, and people in CBO, and there is a general feeling stated in that chapter that there is at least something wrong, that there is not a more correct, accurate estimate. That is what I referred to, and I base it upon what I think is a fair understanding between us, by us meaning myself and CBO, your predecessors as well as the people on your staff for a long period of time. Go ahead.

Mr. **Blum**. I was just going to comment, Senator, that removing bias from economic forecasts reminds me a little bit of trying to remove waste, fraud and abuse from the Federal budget. We do not actually have a line in the forecast called bias that would be easy for us to strike out. Forecasting, as Senator Domenici stated in his opening remarks, is a highly uncertain business. We have to make judgments about a great many events and economic variables, and it is not at all clear where the bias occurs in making those judgments.

As a result of the analysis that we did in the summer and other work, we are very much aware of the problem, and all I can say is that we try to do the best we can.

Senator **Grassley**. Thank you, Mr. Chairman.

Chairman **Chiles**. Thank you, sir.

Senator Sasser?

Senator **Sasser**. Thank you, Mr. Chairman.

Mr. Blum, in looking at your deficit projections there, what is the structural deficit?

Mr. **Blum**. If you would excuse me just a moment, Senator—did we bring that calculation with us? If you will bear with us for a moment.

I am afraid that I would have to——

Senator **Sasser**. What I am trying to do is differentiate between the structural deficit in your numbers and the cyclical deficit. I think that is a very important number to know.

Mr. **Blum**. Right. For the forecast period, 1988 and 1989?

Senator **Sasser**. Yes.

Mr. **Blum**. One way of looking at a so-called structural deficit is on what economists refer to as a standardized-employment basis. On that basis the budget deficit for 1988 is about $130 billion, compared with——

Senator **Sasser**. The 1988 structural deficit is $130 billion?

Mr. **Blum**. $130 billion. That compares with $157 billion for the actual deficit.

Senator **Sasser**. So, you have $29 billion of that deficit that is caused by the cycle, the business cycle, and $130 billion of it is the structural deficit which is caused by outlays that exceed revenues in the best of times.

Mr. **Blum**. That is a good way of characterizing it.

Senator **Sasser**. Now, that is for fiscal year 1988?

Mr. **Blum**. Right. It would increase in 1989.

Senator **Sasser**. It will increase in 1989, because the Tax Reform Act gained us, what, about $30 billion worth of revenues for fiscal year 1988?

Mr. **Blum**. For 1987 it boosted revenues——

Senator **Sasser**. It boosted revenues in 1987.

Mr. **Blum**. And it cost us revenues vis-a-vis the previous tax law in 1988 and in 1989.

Senator **Sasser**. Right. It boosted revenues in 1987 by how much?

Mr. **Blum**. We estimate by about $22 billion.

Senator **Sasser**. You went over that in your testimony. Then it turns around in 1988 and 1989 and costs us revenue.

Mr. **Blum**. That is right.

Senator **Sasser**. And actually increases the structural deficit for 1988 and 1989.

Mr. **Blum**. That is correct. That is shown in table 1 of the statement, which shows that it cost us approximately $10 billion in 1988 and another $16 billion next year.

Senator **Sasser**. I just want to make it crystal clear, this is not a problem of business cycle, slow growth. This is a problem of an on going structural deficit that has been with us now for a number of years and is really exacerbated by the Tax Reform Act now that we passed in 1986.

Mr. **Blum**. That is correct.

Senator **Sasser**. All right. Now, why the difference, Mr. Blum, between the administration projections and your projections? I note that the administration is projecting for fiscal year 1989 a GNP increase of 3.5, and you are projecting a GNP increase of 2.6, and the consensus is a GNP increase of just 2 points.

Mr. **Blum**. That is correct.

Senator **Sasser**. Are you cranking in different economic assumptions, is that the explanation?

Mr. **Blum**. There are several points to be made in responding to your question, Senator. First of all, I think it is useful to keep in mind that all forecasts are uncertain, and from the point of view of the forecasters these differences do not loom very large.

Senator **Sasser**. All right.

Mr. **Blum**. Second, all of the forecasts here essentially show a similar pattern. They all show a slowdown in 1988 and a pick-up in 1989.

Senator **Sasser**. But the answer really is that you are using different economic assumptions and their economic assumptions are rosier than CBO's?

Mr. **Blum**. I think that is a way of looking at it. The administration is counting on a boost of real net exports, as are all the forecasts, but it is more optimistic on other components of the economy.

Senator **Sasser**. Now, you said in your opening statement—let me read it here: "The outlook for the economy depends on the success of the Federal Reserve in supplying the economy with enough credit to avoid a recession, without reigniting inflation or undermining the dollar."

Well, I concur with your judgment in that regard and I think most economists would. At what juncture do we reach the point where we are reigniting inflation, though, to the point that Dr. Greenspan and his colleagues would say we need to tighten the money supply? Do you have a number that comes to mind?

Mr. **Blum**. No, I do not have a particular number for that. Perhaps Dr. Greenspan would. The Federal Reserve is clearly in a very difficult situation, walking very much of a tightrope during this period—having to keep enough liquidity in the economy to avoid a recession in the near term but yet not so much as to bring interest rates so low that the dollar depreciates rapidly.

Senator **Sasser**. At what point do we get a drop in interest rates when the Fed lowers the rates to keep the economy moving, and at what point do you start losing foreign capital? We are presently financing, what, about half of the deficit with foreign capital?

Mr. **Blum**. That is about right.

Senator **Sasser**. It is said that about $140 billion of it is being financed now by foreign capital, so that is about two-thirds, right?

Mr. **Blum**. Yes.

Senator **Sasser**. Do you have an idea at what point we start losing that foreign capital if we start lowering rates?

Mr. **Dreyer**. We have lost private foreign capital recently.

Senator **Sasser**. Would you use the microphone, please, sir? I am having a little difficulty hearing you and I expect that others are.

Mr. **Dreyer**. In recent years, the current account deficit was mostly financed by foreign central banks, rather than by foreign private investment. So, to answer your question directly, Senator, we have lost private foreign capital at least temporarily. It is impossible to say when the resumption of net private capital inflows would resume and under what circumstances.

Senator SASSER. And the foreign central banks are continuing to finance it for what reason, just world political economic considerations, they do not want our economy to go into a——

Mr. DREYER. There is a recognition that too sharp a drop in the dollar would hurt their own exporters, and I would imagine that they are under political and economic pressure similar to those facing U.S. authorities—to avoid very rapid disruptions in the patterns of economic activity.

Senator SASSER. Well, if we fall off into a recession and these deficits start going up, we are faced with a Hobson's choice, are we not? If we try to attack it with revenues, we simply make the recession worse.

Mr. BLUM. There is that risk, yes, sir.

Senator SASSER. My time is up.

Chairman CHILES. Senator Domenici?

Senator DOMENICI. Thank you very much, Mr. Chairman.

Mr. Blum, might I just ask for a clarification. I think most of our staff have communicated to us your January 5th economic assumptions. I note that the economic assumptions have a 2.1 percent real growth rate for 1988, and I am just wondering what happened.

Now, you have a 2.3 percent growth rate in the testimony we are getting today. Is that a real adjustment? Was the first one an error, and if you have readjusted, what did you do for the previous quarters on that?

Mr. BLUM. Senator, we are showing today slightly revised numbers, reflecting the fourth quarter GNP figures that were released last week.

Senator DOMENICI. So, are you telling us then that the 2.3 percent is merely the reflection of more accurate data from the last quarter and therefore it is more apt to be right than the 2.1 percent that we had before?

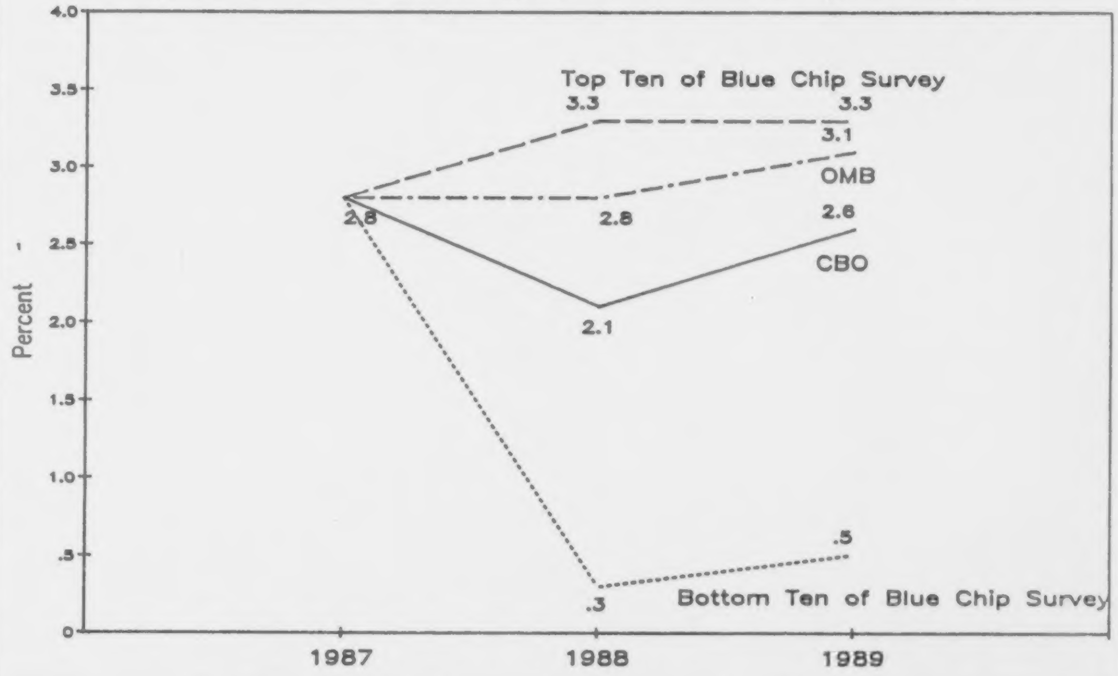
Mr. BLUM. Yes, it reflects an adjustment for what actually happened in the fourth quarter. The forecast given to your staff early in January was put together during the month of December. When the fourth quarter GNP figures came out last week, we updated our forecast. We did not change the essential nature of the forecast, but in order to incorporate the December data some adjustments were needed.

I might point out that the December forecast did hit on the nose the nominal GNP figures for the fourth quarter of last year, so the needed adjustments were relatively small.

Senator DOMENICI. Let me say that, I have the greatest respect for the background information that the Chairman gave us about the future and the effect of the social security trust fund on the future. I know it is going to be a problem. We have been using the enormous social security surpluses in the measure of the unified budget deficit. However, since we worked so hard on the economic summit, I am very interested in trying to find out what this committee ought to do that is responsible with reference to getting a budget out quickly. We need to know how relevant the defense numbers are, as well as the foreign assistance number and cumulative numbers for the discretionary accounts. What is the probability of reaching the $146 billion deficit in July required under Gramm-Rudman?

Actually, I am trying very hard to look at what is being predicted in terms of economic assumptions, just so that eventually we can put that in perspective for the committee. I have just put up a chart there. I just have two of them and I will conclude quickly, Mr. Chairman. Would you put up the first one, "Range of Real Growth Forecasts, Blue Chip Economic Indicators."

Range of Real Growth Forecasts
Blue Chip Economic Indicators
(Percent change, calendar years)



I have now begun to understand what this blue chip forecasting is. This fellow has made a fortune out of some little town in Arizona, as I understand it. What is the name of it?

Chairman CHILES. Blue Chip, Arizona. [Laughter.]

Senator DOMENICI. It will soon be, because he is getting more popular than the town. He is making a lot of money now. He used to do his own forecast and now he asks a whole lot of economists to send their forecasts in. Then he compiles them and he averages them and that becomes known as the Blue Chip forecasts. Everybody pays a lot of money for this, $350 a year just to get a copy of it, and the subscription list is growing.

Do I understand correctly that a very significant portion of the shortfall you have described with reference to the 1989 achievement of the Gramm-Rudman-Hollings deficit, is attributable to 1988 economic assumptions?

Mr. BLUM. You are absolutely right, Senator.

Senator DOMENICI. Now, let me just tell you what I have found out and see if you agree. I have found out that the uncertainty of predictions is really beginning to show up in the blue chip extremes, that the top under blue chip and the bottom under blue chip—and you see it there. The range goes all the way from plus 3.5 to 0.5, and all of the ancillary economic assumptions with it. I am now told by somebody who has talked to the blue chipper himself that that disparity is much bigger than at any time that he has compiled his blue chippers to arrive at an average.

Now, does that mean, if that is true, that because of certain circumstances it is getting more difficult to predict economic assumptions?

Mr. DREYER. The dispersion always widens when there is a suspicion that there is about to be a turning point in the economy.

Senator DOMENICI. All right. So, what we have before the committee is a point in time when those who are doing this for a living have a vested interest in being right, is that not correct, all of those people?

Mr. BLUM. That is correct.

Senator DOMENICI. Now, what I note in that first chart is that for 1988, 33 of those who furnished information to the Arizonan are above CBO as you gave it to us today, and 17 are below, and 2 are the same. That would seem to indicate to me that the reason that the blue chip has such a low GNP average is because of the huge dispersion on the bottom end.

Mr. BLUM. You are correct in your observations, Senator, but I would caution you that these numbers reflect the last blue chip release. It comes out every month, and within about a week's time we are going to get a new release that will take into account the fourth-quarter GNP release. I would wager that you will see some pessimism going into that consensus forecast in the near term as a result of that release.

Senator DOMENICI. Well, we obviously will have to do that when we get it. All I had was his versus yours and——

Mr. **Blum**. That is exactly what we are showing here as well in table 2[1] of the testimony, where we present the consensus, the average of those 50-odd forecasts.

Senator **Domenici**. What I am trying to do is to establish the premise that to the extent that the blue chip has any relevancy, we could move up in GNP from yours and be consistent with 33 economists at least for 1988, We have a compelling majority on our side that you are pessimistic in your economic assumptions on GNP.

Mr. **Blum**. Yes, you are right.

Senator **Domenici**. Now, I do not know all of OMB's assumptions. I read some of them and some were extrapolated.

Mr. Chairman, if she would just put the next chart up, I want to show you the range of deficit forecast that Blue Chip Economic Indicators show. It is very quick and I will just put it up to show you.

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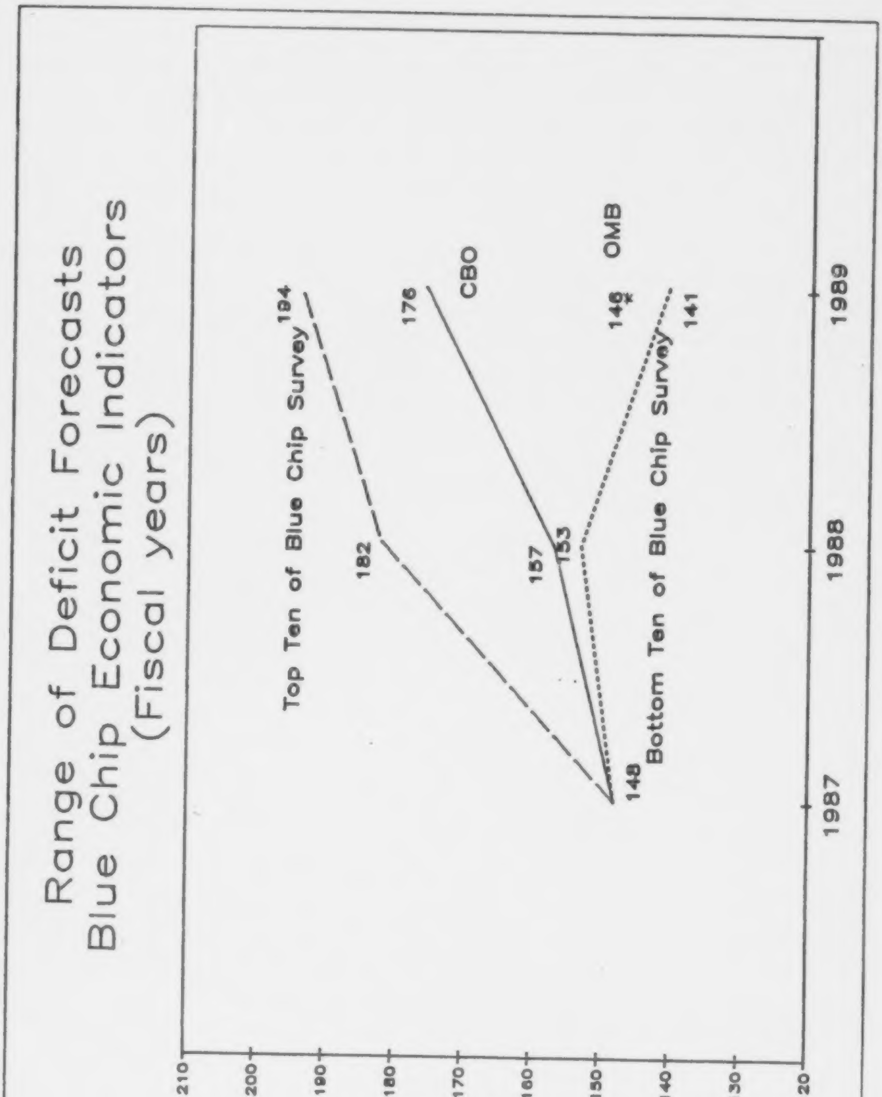
[1] See p. 21.



Range of Deficit Forecasts
Blue Chip Economic Indicators
(Fiscal years)

If you take the average of the bottom 10, Mr. Chairman, you will get the deficits shown in that red line, which are far bigger deficits than even those predicted by Mr. Blum. Then, if you take the ten most optimistic growth forecasts, you can see how much better the deficit is going to look.

I have put OMB's forecast right there in the middle. Then I tried as best I could to take OMB's forecast and calculate that their deficit would come out at about $144 billion. Now, I understand that if we are looking for some mid-range between the top and the bottom, CBO looks like they come out in the middle. I tried to establish the fact that we have such a wide, wide variety of forecasts here, both extreme pessimism and extreme optimism.

I want to conclude by saying that we are not going to be very sure of any forecasts. I want to urge that again we concentrate on enforcing the 2-year summit agreement, because in July, OMB is going to do the final wrap-up in terms of a sequester. I firmly believe that no one can come very close this year and that is going to be the determining factor.

That is not to say that I am not worried about the next 10 years as the Chairman depicted on his charts. I do not know how much confidence you and others have in the new economic commission that is charged with trying to bring this all together, but I think they obviously need to deal with the questions you raised and many more.

I started by saying that I thought there was great uncertainty, you have agreed to that, Mr. Blum. I believe that CBO is pessimistic based on recently released data.

I also think your interest rate forecast just has to be wrong if your GNP growth is right. I do not see how you can have such a low GNP growth rate and a rise in interest rates that you have shown there. The level of interest rates is a substantial portion of our failure to comply with Gramm Rudman-Hollings.

I have one last observation and question: If, on Senator Chiles' chart,[1] with reference to entitlement growth, defense growth, interest growth, if you had put another column over there "tax growth," do you have any idea—perhaps your tax expert would—how much taxes have grown during that same period of time? Could you give us an estimate of that?

Mr. Blum. Sure.

Senator Domenici. And since you are using trust funds and entitlements, it should include all the taxes of the Federal Government.

Mr. Blum. Well, let us see. In 1981, total receipts were $599 billion, and our projected total for 1988 is $897 billion, so that is roughly a $300 billion nominal increase. As a percentage of GNP, however, revenues fall from 20.1 percent of GNP, which was a high mark.

Senator Domenici. What years was that?

Mr. Blum. I am just looking at percentages, revenues as a percentage of total gross national product. Unfortunately, from your point of view, 1981 is a high, bellwether year for revenues as a percentage of GNP, at 20.1 percent. For 1988, they are projected to be 19.2 percent, a decrease of almost 1 percentage point.

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[1] See p. 34.

Senator DOMENICI. Mr. Chairman, I thank you for the time and I just want to summarize by merely saying this to you and to the committee for the record. If we use the forecasts of the top 10 people that submit their blue chip estimates, we would be well within our targets and exceed them if we just accomplished what we did in the summit. And if in fact we use what we think OMB's forecast is going to be, you can see that we will be well within the mark we have to reach by July 15th of this year. I think the solution lies in using the right forecast and not in trying to cut $30 or $40 billion off the deficit.

Thank you very much.

Chairman CHILES. Thank you.

Mr. Blum, I believe you said that revenues grew by roughly $300 billion, and our chart showed that there was a $377 billion increase in spending since 1981. Those figures would indicate spending has grown faster than revenues. It is interesting that the difference is just roughly $77 billion. The interest is $82 billion, so we just borrowed the difference.

Mr. BLUM. That is just another way of looking at it.

Senator DOMENICI. Mr. Chairman, would you just briefly let me——

Chairman CHILES. Yes.

Senator DOMENICI. I did not give the tax figure to indicate that I thought taxes were growing as fast as expenditures. I merely asked because some leave the impression that taxes have been going down and I merely wanted to say that they have in fact gone up substantially.

Mr. BLUM. Yes, sir.

Chairman CHILES. Senator Exon?

Senator EXON. Mr. Blum, thank you for being here today and thank you for presenting your figures that some were shooting down before they were even presented. I like to hear people out and I want to hear you out very closely.

Let me ask you this question: Generally speaking, the economists—and I assume it would be economists on your staff who did the projections for growth and extrapolated those into the figures that you have given here—are those new economists that just came on-board the last year or so? [Laughter.]

Mr. BLUM. No, sir, but I would not want to characterize them as old economists either. [Laughter.]

These are the people who——

Senator EXON. You do not look like you are old enough to have been there very long.

Mr. BLUM. Well, thank you very much, Senator. Actually, I have been with CBO since the very beginning.

Senator EXON. And you have been one of those economists that we like to criticize that have been in on most of the forecasts for OMB since you have been there?

Mr. BLUM. For my duration at the Congressional Budget Office, I have been in charge of all the spending estimates, and I have had to use the economic assumptions that have been produced by another part of CBO. [Laughter.]

But I have worked closely with them, and I think they are an outstanding group.

Senator Exon. It is fair to say there has not been any dramatic changes in the top personnel of the forecasting office, is that right?

Mr. Blum. That is exactly right. Actually, we do have a vacancy. The assistant director for fiscal analysis, Bill Beeman, left government service last summer, and that post has remained unfilled. Jacob Dreyer was his deputy for some time previously and is serving as the acting assistant director for fiscal analysis.

Senator Exon. Well, there is not any reason to conclude, then, is there, as some have concluded and some of the conservative press have already printed, that these projections that you have are a political outrage? You have not ever forecast political outrages before, to my knowledge, and I have never seen your office accused of that.

Seriously, though, what I am trying to get to, there is no reason by the fact that you have got new people doing the estimates that, however far wrong or however far you are right this year, you basically have used the same procedures and basically the same people as in the past, is that correct?

Mr. Blum. Senator, you are absolutely correct. The Congressional Budget Office is a nonpartisan, objective, professional staff organization. We pride ourselves on that, and we work very hard at upholding that tradition.

Senator Exon. Then it is not true, either, is it, that the only reason or purpose of coming forth with these forecasts today is to terrorize the financial markets and perhaps produce a self-fulfilling prophecy of a weak economy? That is not your goal, is it?

Mr. Blum. No, sir, absolutely not. I think you are referring to an article that appeared in the press yesterday. The Feds show that the rather flamboyant language used in that article was in error. It took our projected deficit for 1989 of $176 billion and confused that with the deficit for 1988, the current fiscal year. In fact, our estimate for the current fiscal year is $157 billion. The estimate will in no way terrorize the financial markets. In fact, it is more optimistic than any number that I have seen coming out of Wall Street, from private forecasters or Wall Street analysts. They all have a much higher deficit for the current fiscal year. So, if anything, my statement should soothe the market.

Senator Exon. Thank you. You have not terrorized me. That ought to give you some relief.

Since you have been around CBO for a long time, could you tell me how many years this Committee generally used the OMB figures as a basis for the economic assumptions that were used in developing the budget?

Mr. Blum. It has done so occasionally, most recently last year, when the committee used both sets of economic assumptions. It used the OMB economic assumptions for the purposes of meeting the Balanced Budget Act requirement of reporting a deficit of $108 billion, but it did so in an open manner, showing what the deficit would be if the CBO estimates were used instead. We were at that time projecting a deficit under the budget resolution policies for 1988 of about $134 billion. So, relative to where we were a year ago, the situation has deteriorated somewhat. Most of that was reflected in our summer update report.

Senator EXON. Just assure me a little bit further: You did not conjure up these figures to set the stage for a tax increase, did you?

Mr. BLUM. No, sir.

Senator EXON. Thank you. [Laughter.]

I read these things and I just came all unnerved, because I have had such great respect for your organization for so long.

Let me ask the Chairman of the committee, since—has he gone? Well, let me ask the Ranking Member of the committee—my time is up but let me ask the question anyway—What do you think this committee is going to do this year? It seems to me like, before you ever got the figures, the stage has been set by statements in the press and by a whole series of individuals to set up a confrontation that we have obviously got to use the figures by OMB this year, not the figures of CBO. At least that is what I pick up from what I have been reading. Is that a fair conclusion on my part, or is that just a figment of my imagination?

Senator DOMENICI. Are you asking me?

Senator EXON. Yes, because the Chairman is not here.

Senator DOMENICI. I do not know. To show you how aware I am of the politics of CBO's estimating, I really have not read this article until you brought it up. Frankly, if you are just asking me, I believe that we ought to enforce the agreement that we entered into at the Economic Summit Conference and that ought to be our primary mission.

OMB is going to make the economic assumptions in July without CBO, as I understand it, and I think we ought to know that the Congress of the United States, prompted by the President's State of the Union Address, is not going to sit by and wait 3 or 4 months while we bicker over economic assumptions and assumptions that we make in these various functions. They want a budget resolution that meets the target set in that Economic Summit Conference, and I have a hunch that if we do not do it and do it quickly, that the House will produce appropriations bills and let the budget resolution to go by the boards.

So, I think if we can find a reasonable set of economic assumptions, that will reach the target based upon the cut list and cut assumptions in the Economic Summit, we ought to use them and see what July yields. If it happens to be CBO's that get you there, fine, if it is OMB's, fine, and we will find out about mid-July what the facts are.

Senator EXON. What you are saying, then, is we are locked in with the budget agreement that was reached to just look around and find whatever economic assumptions we can come up with that makes our task the easiest and that automatically is what we are going to use?

Senator DOMENICI. I did not vote for Gramm Rudman II, as you know, the last time through, but we still have to meet it and, frankly, I have looked at the growth in defense and the growth in discretionary that was agreed upon in the summit and I actually firmly do not believe they are the cause of this deficit. If you could go 5 or 6 years with the kind of less than real growth in those accounts, you would have a marvelous budget in terms of those accounts and, frankly, I leave it up to you all. I am here to help, but we have to decide if we are going to address entitlements this year; if we are going to address taxes in any substantial manner this year, or if we are going to enforce the summit agreement that took place?

Senator NICKLES. I wonder if I might ask Mr. Blum a couple of questions.

Senator Exon [presiding]. In the absence of the Chairman, I think it is proper to recognize the Senator from Oklahoma.

Senator NICKLES. I appreciate that from my good friend from Nebraska and also from New Mexico.

Mr. Blum, a couple of quick questions. Your reestimations are that we are going to miss the target for 1988 by $7 billion?

The target was what, $150 billion?

Mr. BLUM. The target in the Balanced Budget Act for 1988 is $144 billion.

Senator NICKLES. And you estimate that 1988 will come out at $157 billion?

Mr. BLUM. That is correct.

Senator NICKLES. And what was the major discrepancy?

Mr. BLUM. The major discrepancy since the budget summit agreement and the actions taken by the Congress in December is the projected slowdown in the economy that——

Senator NICKLES. You project revenues would be down $13 billion?

Mr. BLUM. No, we project revenues to be down almost $10 or $11 billion from where we were last summer, and after the actions taken by the Congress in the reconciliation bill last December.

Senator NICKLES. So primarily we will miss it by $13 billion, and $10 or $11 billion of that is because revenues will be less than anticipated?

Mr. BLUM. That is correct.

Senator NICKLES. Then the difference in 1989 was the difference of—the target in 1989 was what?

Mr. BLUM. The Balanced Budget Act target in 1989 is $136 billion. I think the summit agreement contemplated doing enough to get within shooting distance of that—at least within the $10 billion margin of error.

Senator NICKLES. So you are saying we are going to miss that target by $40 billion unless we taken action?

Mr. BLUM. It could be as much as that. Some additional action is contemplated, however, under the summit agreement. Most of the savings for 1989 were already achieved in the form of permanent changes to tax law, for example, entitlement programs and the like. Also, the base from which we are projecting discretionary appropriations was lowered in 1988.

But the summit agreement does contemplate some additional actions. The most prominent, of course, are the caps, appropriation caps for discretionary appropriations, in both defense and international affairs.

Senator NICKLES. So did you plug those into your estimations?

Mr. BLUM. These are not in our baseline deficit estimate for 1989. But if those caps are adhered to, they would produce, by our reckoning, approximately $3 billion in additional outlay and deficit saving. In addition, the summit agreement contemplates new asset sales of $3.5 billion in 1989.

Finally, the summit agreement anticipates continuing increases in appropriations to the Internal Revenue Service for enhanced enforcement activities. And if that is done as well, it will generate some additional revenue growth, we estimate at about $0.4 billion.

Adding all of these up together, about $7 billion in additional deficit reduction savings are contemplated under the summit agreement. And that would lower the deficit by our calculations from $176 billion down to about $169 billion.

Senator NICKLES. $169 billion. The goal under revised Gramm-Rudman is $136 billion, so we still have about——

Mr. BLUM. $33 billion.

Senator NICKLES. Let me ask you another question. Do you put in an inflation factor in all accounts, in every program under your baseline?

Mr. BLUM. Yes, sir. What we did was to follow the precise specifications set forth in the revised Gramm-Rudman-Hollings Act, the Balanced Budget Act, as to how to calculate the baseline for sequestration purposes. The amendments that were made last September by the Congress to those baseline specifications came very close to duplicating the methodology that CBO has traditionally used for making baseline projections.

Senator NICKLES. Do you not think it would make sense, if we were really in an effort to work off a baseline that we would use last year's figures noninflated for all accounts that do not have automatic COLA's?

Mr. BLUM. That is a way to go. The problem with making comparisons strictly to where we were last year is that a lot of changes happen to the budget under current laws. Revenues will grow, entitlement spending will grow because——

Senator NICKLES. I am aware of that. But what I am saying is that you would not assume inflated accounts for any area that is not mandated by law to have an inflation adjustment. I am aware that entitlements will grow. And I am aware that some entitlements have automatic COLA's. But not all programs.

And I just detest the idea of seeing the baseline inflated in every single category. That is almost admitting defeat before we get started.

Let me ask you two final questions. What is CBO's domestic oil price projections?

Mr. BLUM. For 1988, we are looking at an average acquisition cost of around $17 per barrel, rising about $1 dollar by the end of 1989 to $18.

Senator NICKLES. So $18 or $19? If we repeal the windfall profits tax, would there be any revenue loss in 1988 or 1989?

Mr. BLUM. Not when measured relative to our baseline projections, no, sir. There would be some windfall profit taxes collected, but these would be based on older liabilities, not new liabilities.

Senator NICKLES. One final question, if my friend from Nebraska would allow it.

Senator EXON. Go ahead, Senator.

Senator NICKLES. I appreciate it.

In your technical reestimate in revenues, you show a reduction in 1989 of a minus $5 billion, and a minus $6 billion in 1990. Where are the minus $5 billion and minus $6 billion coming from? Where are we losing the money?

Mr. BLUM. If you do not mind, I will ask Rosemary Marcuss to respond.

Senator NICKLES. Sure.

Ms. MARCUSS. That $5 and $6 billion is comprised of many small pieces, but I can identify the three largest.

Senator NICKLES. Where is the biggest bulk of it?

Ms. MARCUSS. The biggest? It comes from three specific sources. One source, which is responsible for about $1 billion of that downward reduction in each year, is data from tax collections for fiscal year 1987, which indicated that the mix of income taxes was different from our original expectation. There were more taxes from capital gains realizations and fewer taxes from wage and salary withholding. And that led us to reduce our capital gains realizations for 1989 by——

Senator NICKLES. You had more capital gains in 1987, so you reduced it in 1988 and 1989?

Ms. MARCUSS. We raised them for other reasons. But specifically for this timing reason, that there were more capital gains realized in anticipation of the increase in the tax rate in the beginning of 1987 than we had estimated, we reduced our capital gains realization—our revenues from capital gains—by $1 billion in 1989.

Senator NICKLES. And in 1988?

Ms. MARCUSS. And in 1988.

Senator NICKLES. So $1 billion of it was capital gains?

Ms. MARCUSS. Yes; another $1 billion was from a change in the mix of income taxes, where we had thought until the end of the fiscal year that there was more income from wages and salaries and less from other sources of income. Preliminary data on tax liabilities caused us to change our mix of income, reducing receipts by another billion dollars in each of those 2 years.

The third source of revenue reestimates is new information on the accounting provisions of the Tax Reform Act that caused us to reduce the revenue increases, from several of the provisions in the act, by $1 billion in all. So we now see those provisions as raising revenue by $6 billion from current law instead of $7 billion. And we would be happy to provide more detail.

Senator NICKLES. Thank you very much. Thank you, Mr. Chairman.

Chairman CHILES. Senator Grassley, you had some questions?

Senator GRASSLEY. Yes, if I could.

Senator EXON. Chuck, could I just make one statement, and then I have got to leave.

I think it is interesting to note that last year at the White House we had two summit conferences, one with the Soviet Union and one between the President and the Congress. And we have had a lot of discussion about whether or not the arrangements with the Soviet Union are verifiable. We want to make sure that no one is cheating.

After listening to this discussion here today, I suggest that we probably have more cheating going on with the arrangement between the President and the Congress than we have thus far with the Soviet Union. And I suspect——

Chairman CHILES. I know you are saying that in jest, but I do not think that is true. All the testimony I have heard today is that both the President and the Congress have more than lived up to their agreement.

Senator EXON. The figures seem to be so far out of line that——

Chairman CHILES. But those figures are not for policy reasons. They come from the estimates and what the estimaters say is happening as a result of the tax revenue coming in.

But we want to make this clear on the record. Has there been any cheating? Do you think there has been any cheating by either the administration or the Congress in regard to carrying out the agreement?

Mr. BLUM. No, sir.

Chairman CHILES. So far.

Mr. BLUM. That is right.

Senator EXON. That is why I was talking about verifiability.

Mr. BLUM. As you correctly observe, by our estimates the Congress more than fulfilled its end of the bargain for the 1988 deficit reductions contemplated in the summit agreement. The agreement calls for $30 billion. By our reckoning, it is closer to $34 billion.

Chairman CHILES. All right, so rather than $30 billion, we have made $34 billion in savings.

Mr. BLUM. Right. Now there may be a problem in 1989 in achieving the full amount contemplated for that year. But over the 2-year period, doing the $7 billion that I said remained to be done, when added to the amount already accomplished for 1988, will achieve the full 2 years savings contemplated.

Senator EXON. We have already set up, Mr. Chairman, despite what you say or think—and I was not aiming this at you—we have already set up here today, obviously there is going to be a knock-down, drag-out between the economic assumptions and numbers between here and——

Chairman CHILES. That is right. But again, we are talking about estimates there.

Senator EXON. You were out when I asked the question earlier. Could you answer the question now? What is your view on whether we are going to traditionally follow our usual procedures by going with this group for our assumption? Or are we more likely to take——

Chairman CHILES. As you will recall, last year we used both. And I think what we should do is wait to make that decision after we have everything on the record and get a chance to make our own determination about the interest rates and the growth rates.

I am inclined to use CBO, yes. But I think we will wait and make that decision.

Senator EXON. Thank you. I appreciate——

Chairman CHILES. Senator Grassley?

Senator GRASSLEY. Mr. Chairman, I think the discussion that you and Senator Exon just had brings us back to the points that I was making about bias. The August report and, specifically, the chapter previously referred to uses those words, so that is why I feel comfortable talking about it. And I think I cannot disagree with the difficulty of dealing with it, as you suggested. You just do not plug something into your formula for bias and that takes care of it. I do not differ with you on your point.

But I would like to suggest that if over a period of time a forecast is historically optimistic by x percentage on the average that in turn, on the average, we would feel compelled in some way to adjust for forecasts by x percent in terms of its impact on the deficit.

Now I am not an economist, and that is a seat-of-the-pants rationale, yes. But it is supported historically with the figures we have here.

Now while last year your forecast was on the money and was essentially the same as the consensus, this year CBO is right back to its familiar pattern, somewhere right between OMB and the consensus. The table in your August report shows that CBO's biased error is about 1.3 percent—that would be an average from 1980 to 1987—while that of the average of the other forecasters is roughly half of that error.

While 1.3 percent error might appear to be small, that is really about $44 billion on average. And that again is from your report.

If CBO were to reduce its bias factor from that 1.3 percentage to just—and you can take anything out of the clear blue sky, but I took 0.75 percent, the average of what the private forecasters use—we would eliminate $20 billion worth of optimistic bias in our deficit projections. Is that a fair assumption? Or is that too simplified?

Mr. **Dreyer**. Can I answer?

Senator **Grassley**. Yes.

Mr. **Dreyer**. First of all, over the period which is reported in this appendix, the 1980's essentially, other forecasters made errors of similar size as well. And there was a general upward bias across all the forecasters that we surveyed.

If we decided to do what you suggest and simply adjusted our forecast by a constant, our error would not be diminished. We would now be trying to compensate for the reported bias in the past by being biased in the opposite direction in the future. The error would increase in any particular year over which the bias was reduced deliberately.

But more important, we just do not know how to do it, because we do not know exactly where the bias resided—in which portion of the forecast, and in which component of the projected economy.

Senator **Grassley**. But I think that there is a commitment that you will try to do that.

Mr. **Dreyer**. We are trying to forecast as well as we can to reduce both the bias—that is to say, the systematic or average under or over-prediction, and the variance, which is simply, the spread, the dispersion, the range of uncertainty. And believe me, that is not a simple task.

A purely mechanical model over the 1980-86 period, without any human judgment, shows bias of the same sign as CBO's bias and everybody else's bias. There was something in the economy which distorted the pattern relative to previous history, and which caused all forecasters to err on the same side.

Mr. **Blum**. In looking at the analysis that we did last summer, it turns out that the signs of the errors change from year to year.

Sometimes we are too high, sometimes we are too low. That is one point.

Another point is that all forecasters tended to err in the same direction. And the problem in looking ahead is to know which direction you are likely to be erring in after everything is said is done.

The one thing economists are very bad at doing is predicting turning points in the economy. We are influenced very strongly by historical trends and recent data. We cannot tell with any accuracy when the economy is going to turn and go in the other direction.

We could make a tremendous error, when we look back and do this kind of historical analysis, if we were led by it to shade our best judgment in one way or another. And I think that is our basic problem.

Senator **Grassley**. The only thing is, that of all the various estimaters, CBO is off the most. Now that sounds like I am trying to beat you over the head, but that is not my point because you sincerely approach this professionally. And it is not my intent to question how sincere you are about it.

But we are politicians. And it is too doggone easy for us in Congress, as politicians, to take the easy way out. And you see, the more optimistic you are, then the greater our problem is.

So my point is that while some would suggest your projections may be too pessimistic, I think I want to caution people not about pessimism but to be realistic, because we on this committee, and Congress as a whole are the principal consumers of your product. And as I said, we fall prey to that optimism because it makes our job a little bit easier hitting these targets.

I believe the committee should be worried about eliminating bias in our GNP forecasting, if that has been the main source of our misestimating over the last years, and it has been. And particularly next year when we are going to have a new President coming in whether he is Republican or Democrat.

Everybody knows that that President is going to face a major problem because the budget summit basically put off to the new President the task of really biting the bullet. He is going to have one shot that first year he is in office, when he is going to enjoy public support and have a honeymoon with the press, to get this under control.

Regardless of how sincere you are it is easy for us to accept those figures of optimism. By doing so we are going to compound the problems for next year. We are always putting off to another day—manana—the solution to our problems.

So I guess it is my hope that throughout this year, and particularly getting ready for the next, that this committee and CBO give serious consideration to remain closer to the consensus forecast, since the consensus has been most consistently in line with the actual. I noted that CBO says in this August update that it is, "Carefully reviewing its estimating procedures in an attempt to minimize the economic and technical estimating errors identified."

So I would hope that CBO would do all that it can during this year to eliminate the biases in its estimates to the extent possible, so that we can begin to get a better handle on this deficit and not compound it any more for next year when we really have to bite the bullet.

Mr. **Blum**. I can give you our assurance of that.

Senator **Grassley**. Thank you.

Senator **Exon**. Thank you, Senator Grassley. I think we will wind this down. I just have a statement or two to make—it may be a question.

I think what some of us have been trying to tell you and put it in another word, well done. I think you have attacked this, as Senator Grassley said, from a very professional manner. You may be wrong. No one is ever always right.

I would just say that if there is one thing that has happened over and over again for the number of years that I have served on this committee. That is that we have usually jumped at the opportunity for the good news that comes out in forecast. And if there is one thing primarily wrong with the Gramm-Rudman bill is that it relies too heavily on going ahead with the forecast and then Katey bar the door after that.

So I think, just listening, and my guess is, that you are probably closer to being correct, looking into my non-professional crystal ball, than the other forecasts. I think though that probably, when I view what is going on today, last week the interest rates in West Germany went up 0.5 percent, and in the United States of America they went down 0.5 percent. I do not know why that was. But really, I know.

And if there is one thing wrong with your estimates, Mr. Blum, in my opinion, is that you probably have underestimated the extent that the administration is going to go to make sure that we do not have a recession this year. And I do not happen to agree with your estimate that interest rates are going to be higher in 1988. They are probably going to stay the same, or I think they may go a little bit lower, or as low as they have to go to get us by the 1988 elections.

And if there is a fundamental built-in error in your assumptions, I assume you have been so professional that you have not taken into fact some political considerations that are going to be made for calendar 1988 that may unfortunately, as Senator Grassley has pointed out, come home to haunt us when we start working on this next year.

I see no other of my colleagues here. So thanking you all for coming and the usual professional job that you do. We are adjourned.

Mr. **Blum**. Thank you.

[Whereupon, at 5:10 p.m., the committee meeting was concluded.]

WRITTEN QUESTION FROM SENATOR DANFORTH TO MR. BLUM AND THE RESPONSE

EFFECTS OF EXPIRING TAX CREDITS ON REVENUES

Question:

Most of the tax provisions scheduled to expire this year are tax credits. Bills have already been introduced in Congress to extend some credits such as the research and development tax credit, the targeted jobs tax credit, and mortgage development bonds. What effect would extending any of these credits have on the revenue baseline? What is the revenue loss associated with extending the expiring tax credits?

Answer:

The CBO revenue baseline does not assume extension of these tax credits beyond their scheduled expiration dates. Therefore, extension of these tax credits would reduce baseline revenues. CBO agrees with the Joint Committee on Taxation's estimates of the revenue losses attributable to extending expiring tax credits. These revenue losses are shown on the table below.

Revenue Effects From Extension of Certain Expiring Tax Credits

(By fiscal year, in millions of dollars)

	1988	1989	1990	1991
Business Energy Credit				
Biomass a/	-47	-81	-85	-90
Other b/	---	-35	-50	-48
Targeted Jobs Tax Credit b/	---	-40	-161	-307
Credit for Increasing R&D Activities b/	---	-401	-816	-1,023
Mortgage Revenue Bonds b/	---	-10	-59	-165

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a/ Scheduled to expire December 31, 1987.
b/ Scheduled to expire December 31, 1988.

VIEWS OF THE REAGAN ADMINISTRATION

FRIDAY, FEBRUARY 19, 1988

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 9:40 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Hollings, Sasser, Riegle, Exon, Lautenberg, Simon, Sanford, Wirth, Conrad, Domenici, Grassley, Kasten, Quayle, Danforth, and Nickles.

Staff present: Richard N. Brandon, staff director; and Alan Cohen, assistant director for budget priorities.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman Chiles. Good morning, Dr. Miller, and welcome to the Senate Budget Committee.

We are glad to have you with us. You may have noticed that since your last visit to this committee, we have added a right wing and a left wing to the table up front. You are in the middle, so I guess that makes you a moderate. In any case, you are surrounded.

I want to begin by offering my compliments on the work you did putting together the administration's budget. I know you have invested a lot of effort trying to comply with the summit agreement. Those of us who were involved in last year's meetings remember the sweat, the time, and the pain involved. And although we could have done much better, I suppose we can take some satisfaction in what was achieved.

Tough as it was, the job facing the next President will make last year look like a walk down primrose lane. When he takes office, the new President will have to face the prospect of a $4 trillion national debt by the end of his term. It is the kind of debt that can smother our own economy and inflict serious damage on the economies of the rest of the world.

Figures from the Congressional Budget Office show we carried out last year's agreement, but that the deficits are already higher because of changes in economics. Clearly, all of us share the responsibility to help hold the line against deficit-creep under the current agreement. But we have to be careful not to treat the agreement like an easy chair where we can sit back and ride out the elections.

If events change, if the markets go haywire again, or any other events snap the economic pressure valve, we certainly have to be ready to move decisively.

With that note of caution, let me say I am impressed by some of the major pieces in your proposal. NASA needs a plan they can count on, and your budget moves in that direction. After the unrealistic proposals last year, I am glad to see an increase in education funding and that military spending is held in check for 1989. You cannot help but be encouraged over the commitment to AIDS research, biomedical research, and a program for catastrophic health insurance.

Of course, after last year's cuts, it is good to see a renewed commitment to the war on drugs and a larger investment in the air traffic control system. After 8 years, it looks like you have finally seen the light on education, drug enforcement, health, and the environment. We are about ready to welcome you to the ranks of the faithful, even though perhaps there are a few more things that you could learn, like how to restore the two-thirds you cut from programs for the homeless.

You made some progress, but I am afraid the budget also includes a few things likely to tarnish in a hurry. For one thing, the budget contains $10 billion in asset sales you could not include in the Gramm-Rudman-Hollings measure of the deficit. As I remember last year's agreement, we ruled out asset sales since all they do is give us shadow cuts in the deficit. Once the sun goes down on this year's budget, the savings from asset sales disappear.

I am equally concerned about the Gramm-Rudman-Hollings targets. With this budget, we miss the targets in the out-years and only meet it this year because of those asset sales. We raised the targets last year to make them more realistic. But they have been missed again, and I think we have to do better.

Finally, we come to the question of the actual size of the deficit. Social security is running a surplus; and since we count this surplus in the deficit, it alters the appearance of the deficit but not the Federal deficit itself. Take out the social security surplus, and the deficit is closer to $185 billion in 1989 than to $140 billion, even using OMB's optimistic economic assumptions.

We can do that sort of thing for a while, but much sooner than later, there is going to be an accounting. And all the hot-wired calculators in the country will not hide the fact that deficits are still high and the national debt is a monster.

Your budget has some problems, but it also has some genuine potential. With some adjustments, I think it will help us keep the deficit from growing. What concerns me most is the painful era of hard choices that almost certainly is ahead of us.

Generally, the budget is in the same ball park with last year's summit agreement, and I think it basically complies. It is a good effort, but chances are you will not be the budget director to come before this committee next year. Ronald Reagan will be in California; I will be in Florida; and all of us, like everyone in the Nation, will be living with the economic conditions as the next President finds them.

I think we have an obligation this year to leave him some options in the continuing fight against the deficit. The best way we can do that, it seems to me, is make this year's budget as realistically tough and honest as we can. To that end, you can be sure of our willingness to work with you and the administration. We were bipartisan last year at the end, and that is a plus. Now, we have to take a step beyond that. We have to be no-nonsense.

So, Dr. Miller, I look forward to hearing from you this morning and your cooperation in the days ahead.

Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Mr. Chairman, I too want to welcome the director. I look forward to his testimony as we begin what I hope will be an expedited year in producing the FY 1989 budget. I have had a brief opportunity to review the broad outline of the budget you proposed on behalf of the President, and I know that there are a number of details that will come up as this committee, the Appropriations Committee and the Authorizing Committees continue their normal review process.

With what I have seen so far, I believe that President Reagan's last budget submission to this Congress represents a good-faith effort to meet the historic bipartisan summit agreement of last fall. Equally as important, it sets a framework for Congress, at least as I see it, to act quickly on the budget and appropriations and, if authorizations are needed, to do them all in a timely manner.

If ever there was a year that we could complete our work on time, it seems to me that this is the year. Those issues that have divided the administration and the Congress over the years and that have added so much delay in getting a budget resolution, at least as I view them, have been resolved. Because for the most part, those issues had to do with defense, foreign assistance, and the rest of the discretionary appropriated budget.

I believe that as a Congress we have agreed on those with the President. I hope that our committee will merely enforce that agreement. I believe we should be the enforcer, and I concur that we should do that diligently. And, indeed, we should not in any way find escape valves from those three agreed-upon total budget authority and outlay proposals.

I find nothing to indicate that the President has violated the essence of the agreement. Consequently, it seems to me that we ought to proceed to enforce it. Obviously, there remains the ongoing battle that we always have of priorities. Where do we permit parts of the appropriated accounts to grow, and where do we want some to be slowed or eliminated?

I think there is one difference this year that is significant. The chairman and a majority of this committee agree that we have set the numbers in defense, that we have set the numbers in foreign assistance, and we have set the number for all the rest. It seems to me that for those who want programs to increase, they will have to find offsets. Our distinguished chairman has just complimented you for increasing the areas of science and research and NASA. Obviously, if programs like that or AIDS research, which you recommend an increase in, or drug enforcement, are going to be increased, there is one difference this year. Offsets will have to come out of the cumulative domestic discretionary accounts. We cannot go off into defense or some other area and borrow from one account to another.

That is a significantly different activity, and it is in a very real sense the result of budgeting on a 2-year basis. Obviously we still have the economic assumptions issue, but that can be resolved if we assume OMB's economies. We have very little latitude to increase programs dramatically unless we either cut others or eliminate some on the domestic side.

This is my last comment. I do not know if this is your work, but I do compliment you as part of the team. I believe for the first time in 8 years the defense budget of the United States has been reoriented. The planned expenditures have been overhauled, so to speak, based upon the realization that we have reached a point in time where we know defense is not going to go up as expected by the administration or the joint chiefs. Somebody did a lot of work, Secretary Carlucci, the joint chiefs and others, and very significant portions of the defense budget have been changed to accommodate the summit number.

We do not have the responsibility, as I understand it, to go into the details, but I do predict that this year, for a change, there will be a real battle as to whether or not areas of defense have been cut too much, not too little. I think that will occur in the ensuing few months, but hopefully not here because I think we have already agreed upon the number.

Thank you, Mr. Chairman. It will be a pleasure to try to work toward an expedited and bipartisan budget this year. Thank you very much.

Chairman CHILES. Thank you.

Dr. Miller, yesterday over at the House of Representatives, you did a great job, I am told, taking the membership through the budget in great detail. We are certainly grateful for that. We do not want to tire you by forcing you to do that all over again.

The first year I was in the Senate back in 1971, we had extended debate some four times. One of those debates took 6 weeks, and all we were talking about was a change in the Senate Rules. As a matter of fact, our colleague, Strom Thurmond, one time back in 1957, made a speech that lasted 24 hours and 18 minutes. Strom is a great favorite of us all, and we do not want to see his record broken today.

I would like to ask you to summarize your main points in 10 to 15 minutes; and if we have any questions, maybe we can have a look at some of your visual aids. I think we have some questions we would like to ask you. So if you will, just give it to us in a nutshell.

STATEMENT OF HON. JAMES C. MILLER III, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. MILLER. Mr. Chairman, thank you very much. I appreciate the chance to be with you today. The administration has carried out, faithfully I think, the bipartisan budget agreement. We did not exceed any of the discretionary budget authority and outlay targets agreed to last November.

In terms of particulars, the defense budget exhausts all of the budget authority and the outlays that we agreed to in the bipartisan budget agreement. The international affairs budget exhausts the budget authority limits. It does not exhaust the outlay limit because, simply, the budget authority and outlays mismatched.

In the domestic area, the budget the President has submitted almost exhausts the budget authority limits and comes extremely close to exhausting the outlay limits. Our intent was to thoroughly exhaust the outlay limits; but when you have to make all these thousands of decisions and add all these things up, when the computers spit out the number, it spit out a number that was 0.1—that is OMB parlance for $100 million—0.1 less than the budget outlay cap. Obviously, if the Congress wished to increase domestic spending by another $100 million, that would be consistent with the budget agreement. And the President would, of course, accept that.

We show a deficit of about $130 billion. In fact, the number is $129.5. That is $6.5 billion below the Gramm-Rudman-Hollings maximum target of $136 billion for fiscal year 1989.

Then, of course, as you know, in the algorithm—that is, the rules, the formula—that you have to apply to determine next August whether there would be a sequester, and if so, how much, it involves excluding from the President's budget the asset sales, but also making a number of arcane changes. That number comes out to be $142.7 billion, which is slightly below the $146 billion cutoff that would require a sequester. So we have avoided a sequester, but it is a darn close thing.

As I indicated to you, Mr. Chairman, and Senator Domenici in the budget negotiations that we had last November, I was concerned that there was a possibility that when we carried out the four corners of the bipartisan budget agreement, we might not hit the targets required by the Gramm-Rudman-Hollings Act. And if that were the case, that we would abide by the spirit of the bipartisan agreement in reaching those targets.

As it turned out, the four corners of the budget agreement does get us within the Gramm-Rudman-Hollings target. But in terms of the algorithm that you apply to determine whether there would be a sequester, there is not much margin for error.

I look forward to working with you, Mr. Chairman, and other members of the committee in finding ways to carry out this bipartisan agreement without touching the historic tax reforms that you passed in 1986, and also avoiding a sequester which I think would not be in our interest to do and not in the public interest.

Now, if I might, I would like to just summarize the major salient features of the President's budget. Again, number one, it comports 100 percent, in our judgment, with the bipartisan budget agreement reached last November. Secondly, it meets the Gramm-Rudman-Hollings targets. Thirdly, within the discretion afforded by the agreement, the domestic discretionary portion emphasizes AIDS research, treatment, and education. It emphasizes drug interdiction, treatment, and education. It emphasizes space and science research. For example, we would double the research budget of the National Science Foundation over 5 years. It also emphasizes hazardous waste cleanup, law enforcement, and support for the elderly and the poor.

Within the numbers, as you said, Senator Domenici, within the top line afforded for the defense budget for this year, we have had to make a lot of hard choices. Mr. Carlucci, the Secretary of the Defense, and our folks here at OMB, have all worked very hard together in order to come up with the best ranking of priorities to have the leanest and the meanest, in our way of saying, defense budget for the top line that has been afforded.

We have done the best we can also within the problems of earmarking, et cetera, for our international affairs budget. And, again, within our domestic budget, we have carried this out.

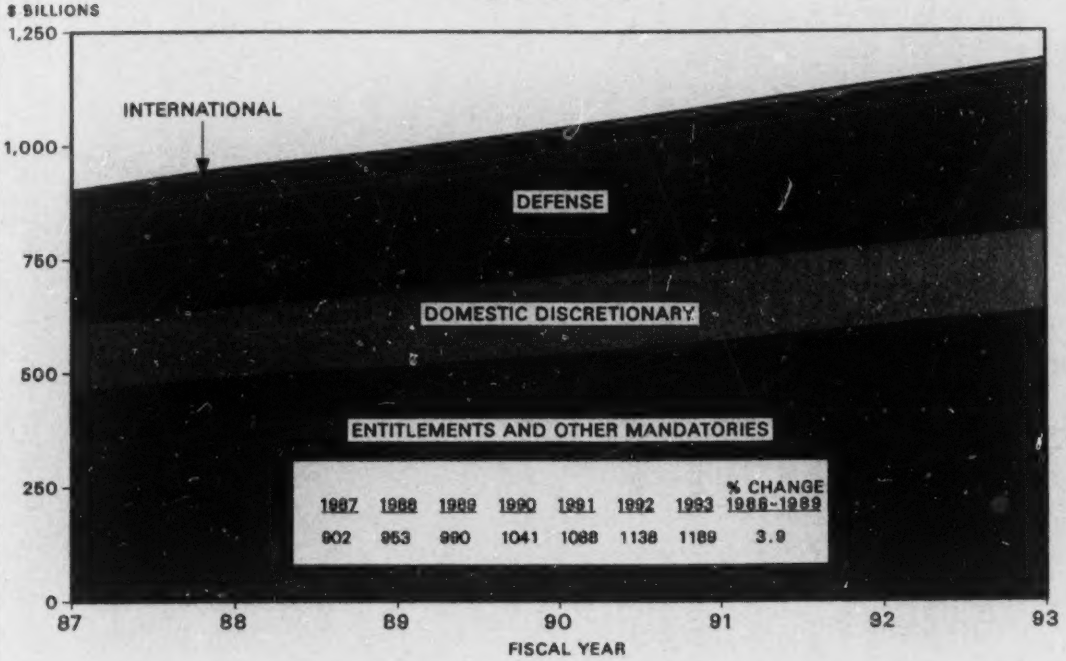
In the entitlements area, we have made only those changes agreed to in the bipartisan budget agreement. We have not gone beyond that, and that is quite different from what is ordinarily the case. Because, ordinarily, the President's budget would propose numerous changes in entitlement programs and saving a lot of money there.

But a deal is a deal, and the President has kept his word and has carried out his part of the bipartisan budget agreement, and this is consistent with the President's budget. In our judgment, it is thoroughly consistent and responsive to this bipartisan budget agreement.

If you want, I will leave it up to you, Mr. Chairman. I could make a presentation involving some of these charts from "Highlights of President's FY 1989 Budget." You have the materials in front of you. I guess I would draw your attention to a couple of pages, if I might.

On page 9, you will see, and I think people in the audience have this. Could you put up page 9?

PROGRAM COMPONENTS OF THE FY 1989 BUDGET*
(OUTLAYS)



1987	1988	1989	1990	1991	1992	1993	% CHANGE 1988-1989
902	953	990	1041	1088	1138	1189	3.9

*Excludes net interest, asset sales, and undistributed offsetting receipts.

As you can see, here are the three major programmatic components of the President's budget. International spending is the very small wedge on the top; defense spending here; and discretionary domestic spending; and then the entitlements and other mandatory areas in the budget. As you can see, the entitlements and mandatory areas are about half of the budget. Altogether, total spending will go up about 3.9 percent for the fiscal year 1989 over 1988.

If I could just mention to you quickly the rates of spending, let us look at the next chart on page 10. The spending on defense outlays would go up between 1988 and 1989 by 3 percent. International discretionary spending will go down by 1 percent. Domestic discretionary spending will go up by 5.3 percent, and entitlement programs will go up by 4 percent. That masks the fact that agricultural spending will go down. It has been at very historically high levels, especially in 1986, but it has come down somewhat because the agricultural markets are much improved. We have greater opportunities to export, et cetera, and so the need for crop subsidies is not nearly as great as it has been in the past.

FY 1989 BUDGET: MAJOR COMPONENTS
(outlays in billions of dollars)

	Fiscal Year							% Change	% Change
	1987	1988	1989	1990	1991	1992	1993	1988-89	1988-93
Defense	282.0	285.4	294.0	306.2	320.2	335.4	351.3	3.0	23.1
International Discretionary	12.8	15.8	15.6	17.0	17.1	17.0	17.1	-1.0	8.2
Domestic Discretionary	148.1	160.6	169.1	177.3	179.0	180.5	182.7	5.3	13.7
Entitlements and Other Mandatory Programs	459.6	491.6	511.5	540.1	572.2	604.7	637.5	4.0	29.7
Subtotal: Program Components	902.5	953.4	990.2	1040.7	1088.5	1137.6	1188.5	3.9	24.7
Net Interest	138.6	147.9	151.6	156.1	158.8	151.0	141.5	2.5	-4.3
Asset Sales	0	-9.3	-10.0	-8.0	-.9	-2.3	-1.0	7.6	-88.9
Undistributed Offsetting Receipts	-36.5	-36.1	-37.7	-40.6	-42.7	-45.3	-47.7	4.3	32.0
Total	1004.6	1055.9	1094.2	1148.3	1203.7	1241.0	1281.3	3.6	21.3

Without going into detail, let me mention the table on page 20 that illustrates the components of the domestic discretionary spending areas. As you can see there, health research and services will go up by 6.2 percent; space and science under the President's budget will go up by 20.2 percent; economic subsidies and development will go up about 4.2 percent; and law enforcement and other core functions of government will go up by 7.5 percent.

DOMESTIC DISCRETIONARY: MAJOR CATEGORIES
(outlays in billions of dollars)

	Fiscal Year							% Change
	1987	1988	1989	1990	1991	1992	1993	1988-89
Health research and services	20.9	22.8	24.2	25.1	25.7	26.1	26.5	6.2
Space and science	9.2	10.9	13.1	15.2	16.8	17.5	18.0	20.2
Economic subsidies and development	38.6	41.4	43.1	44.6	42.5	41.6	41.0	4.2
Law enforcement and other core functions of government	24.7	27.2	29.3	31.4	33.2	34.8	36.8	7.5
Transportation and public works	26.7	28.4	28.3	28.7	28.2	27.8	27.3	0.0
Education and social services	27.9	30.0	31.1	32.4	32.5	32.7	33.0	3.6
Total	148.1	160.6	169.1	177.3	179.0	180.5	182.7	5.3

Transportation and public works would not be changed, but, again, this masks the fact that within those accounts there are some changes including a proposed reduction in mass transit subsidies, capital subsidies which we found to be most cost inefficient. There is a substantial increase for the Federal Aviation Administration for hiring additional air traffic controllers and also for the modernization of the aircraft control system.

Education and social services would go up by 3.6 percent.

Senator DOMENICI. Mr. Chairman, might I ask a question?

Chairman CHILES. Yes, sir.

Senator DOMENICI. The percentages that you are stating here are all outlays year over year?

Mr. MILLER. They are outlays in billions of dollars.

Senator DOMENICI. That previous one that showed outlays 3 percent on defense and 5 or whatever it was——

Mr. MILLER. Same basis.

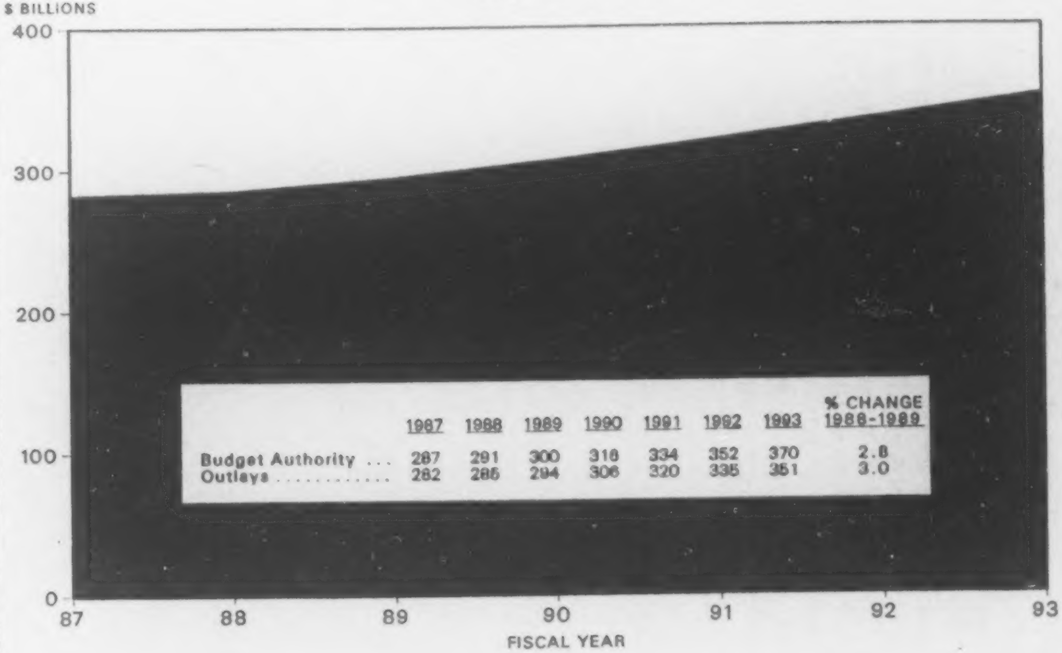
Senator DOMENICI. Do you have quickly what the budget authority increase is? I do not want you to waste any time.

Mr. MILLER. I surely do.

Senator DOMENICI. I assume it is less than both, is it not?

Mr. MILLER. Senator, if you will look at page 11 of the package that you have there, the budget authority increase for defense is 2.8 percent as compared with 3.0 percent in outlays. For international discretionary accounts, the budget authority increase is 1.6 percent as opposed to the minus 1.0 percent in outlays.

NATIONAL DEFENSE
(OUTLAYS)



	1987	1988	1989	1990	1991	1992	1993	% CHANGE 1988-1989
Budget Authority ...	287	291	300	318	334	352	370	2.8
Outlays	282	285	294	306	320	335	351	3.0

Senator DOMENICI. And the cumulative domestic discretionary?

Mr. MILLER. Domestic discretionary is a 3.1 percent increase in total budget authority and a 5.3 percent increase in outlays.

Now, let us put up the table on page 27, if we could view that just a moment. This shows the component parts, Mr. Chairman, of the entitlements package, and there we see that retirement and unemployment expenditures will go up 6.3 percent; that is social security, military retirement, Federal civilian retirement, unemployment insurance, et cetera. Medical care, entitlements, will go up by 6.4 percent. Low-income benefits will go up 2 percent. This masks the fact that with a better economy, with growth in total employment and a reduction in unemployment, there will be less need for as large a volume. But those who are still in low-income areas will receive good support.

ENTITLEMENTS AND OTHER MANDATORY PROGRAMS: MAJOR CATEGORIES
(outlays in billions of dollars)

	Fiscal Year							% Change
	1987	1988	1989	1990	1991	1992	1993	1988-89
Retirement and unemployment	284.4	297.1	315.9	335.0	353.3	370.7	387.6	6.3
Medical care/health	102.8	109.6	116.6	130.2	144.1	160.2	176.5	6.4
Low income benefits	39.7	44.6	45.5	45.4	48.1	50.4	51.8	2.0
Agriculture	25.2	20.5	19.8	17.9	17.1	16.3	14.7	-3.6
Other*	7.5	19.8	13.7	11.6	9.5	7.1	6.8	-30.7
Total	459.6	491.6	511.5	540.1	572.2	604.7	637.5	4.0

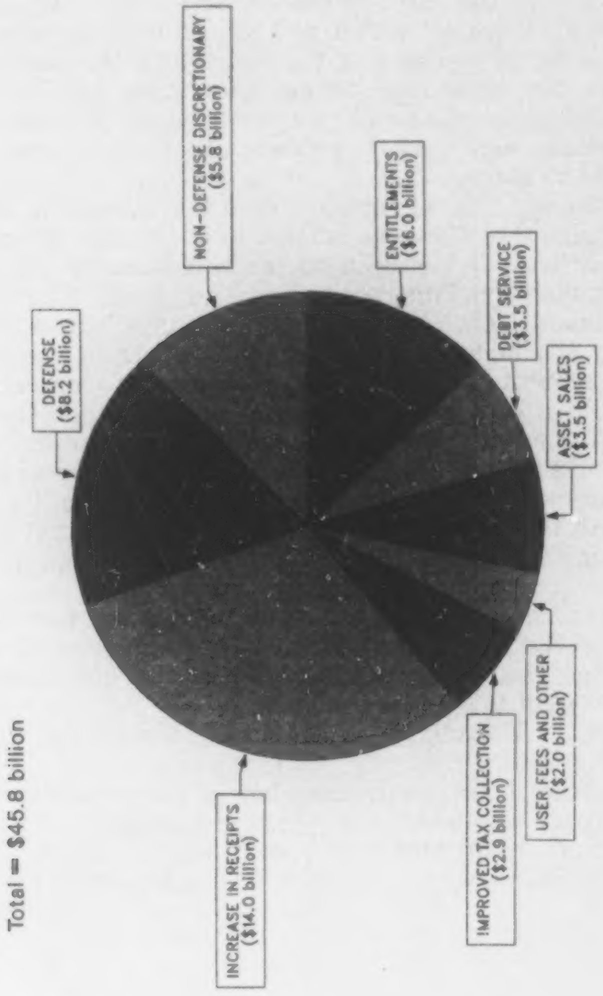
---

* Includes payments by the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation, as well as mandatory international affairs outlays such as repayment of foreign assistance loans and activities of the foreign military sales trust fund.

Agriculture would be minus 3.6 percent, again not because we are proposing any changes, but because under the Farm Bill of 1985 and the amendments that were contained in reconciliation pursuant to the budget agreement, there will be less crop subsidies. Other entitlements go down because less money would be required for FSLIC and FDIC in the coming year as opposed to what we had last year.

The total amount, the total spending for entitlements programs, is $511.5 billion. This compares with essentially a $1.1 trillion budget. So you can see that entitlement spending is about one-half of the budget.

Can we see the next one on page 28? The next chart is a pie chart which simply illustrates the savings, the sources of the savings, that were agreed to in the bipartisan budget agreement. The left half is essentially the revenue side, and this is the outlay side, the right side. The defense budget was a reduction, a savings of about $8.2 billion. For non-defense discretionary spending, we agreed to a savings of $5.8 billion. Entitlement spending would go down by $6.0 billion. Those were savings on the expenditure side. On the revenue side, we agreed to $14.0 billion.



SOURCES OF BIPARTISAN BUDGET AGREEMENT DEFICIT REDUCTION FOR FY 1989

I want to stress to everyone, because some people have misreported it. Perhaps I was not as clear yesterday as I might have been. This $14 billion has already been enacted into law. This was included in the Reconciliation Act of 1988. This is not a new tax increase. This is simply reflecting the sources of the savings that we agreed to in the bipartisan budget agreement last November. Improved tax collection of $2.9 billion, user fees of $2 billion, asset sales of $3.5 billion, debt service because you have a lower deficit and a lower debt to carry.

Finally, let me say, Mr. Chairman, that the President asked in his budget message that there be reform in the budget process. We all know how difficult it has been to reach closure on the budget. The President asked the Congress to consider giving him a constitutional amendment to balance the budget, to give him a line item veto, to convert the budget resolution from a current resolution—that is, an agreement between the two Houses of Congress—into one that would be a joint resolution, basically a law; and that those allocations contained in that budget resolution be faithfully discharged. He would ask for enhanced rescission authority if he were not able to obtain a line item veto. He proposes biennial budgeting. And finally, with the request that he has had before, that there be a truth in budgeting provision for the Congress when it enacts laws.

Mr. Chairman, I have, as you know, a package put together specifically for the Budget Committees of charts cross-walking the President's budget into functional categories by individual functions. I would be glad to go over that.

Chairman CHILES. The charts will be put in the record, and each of us will study them.

Mr. MILLER. Fine. I hope each member of the committee has a copy of this package which contains those cross-walks.

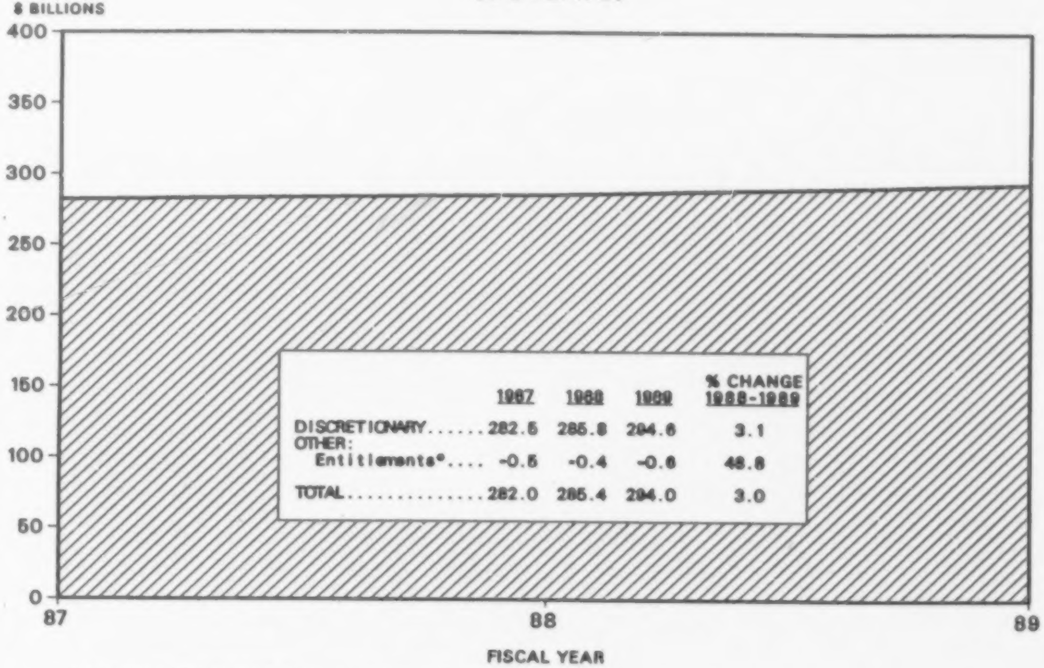
Chairman CHILES. I will give them a quiz on it shortly.

[The following charts were submitted for the record by OMB:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET

PRESIDENT'S FY 1989 BUDGET: BY FUNCTION

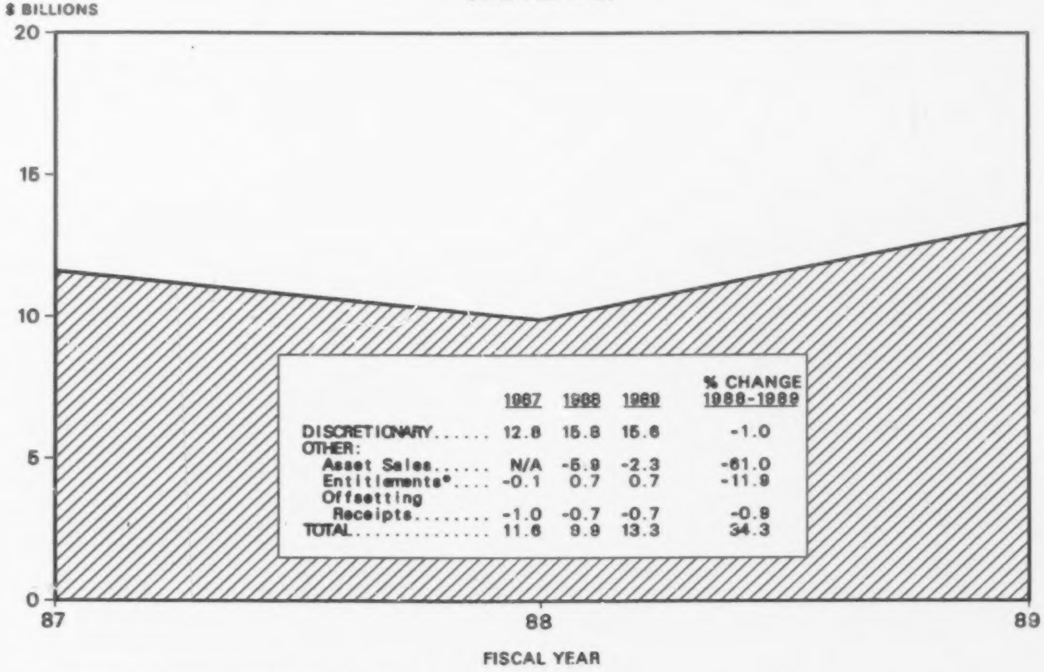
NATIONAL DEFENSE - 050
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	282.5	285.8	294.6	3.1
OTHER:				
Entitlements*....	-0.5	-0.4	-0.6	48.8
TOTAL...............	282.0	285.4	294.0	3.0

* Includes other mandatory programs and offsetting receipts.

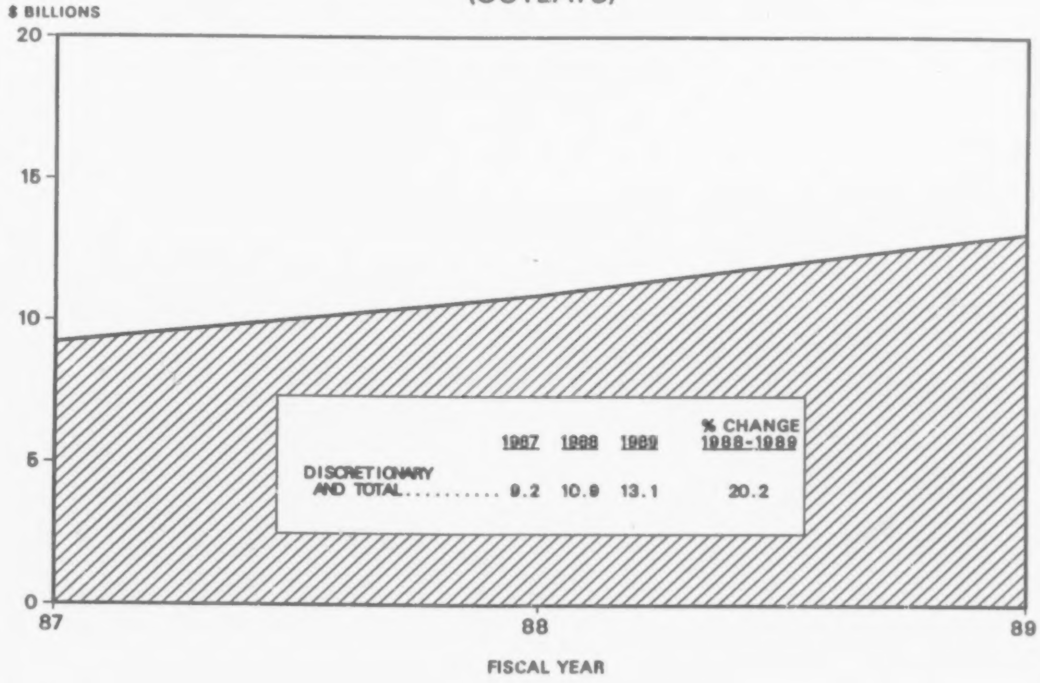
INTERNATIONAL AFFAIRS - 150
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY.......	12.8	15.8	15.6	-1.0
OTHER:				
Asset Sales.......	N/A	-5.9	-2.3	-61.0
Entitlements*.....	-0.1	0.7	0.7	-11.9
Offsetting Receipts.........	-1.0	-0.7	-0.7	-0.9
TOTAL...............	11.6	9.9	13.3	34.3

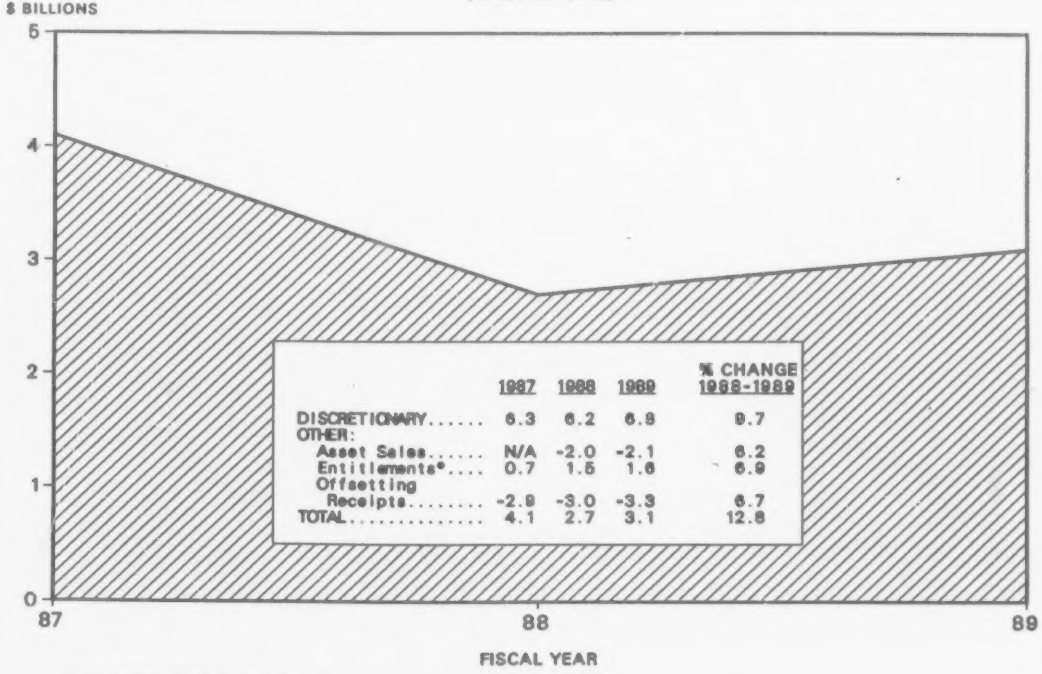
* Includes other mandatory programs.

GENERAL SCIENCE, SPACE AND TECHNOLOGY - 250
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY AND TOTAL..........	9.2	10.9	13.1	20.2

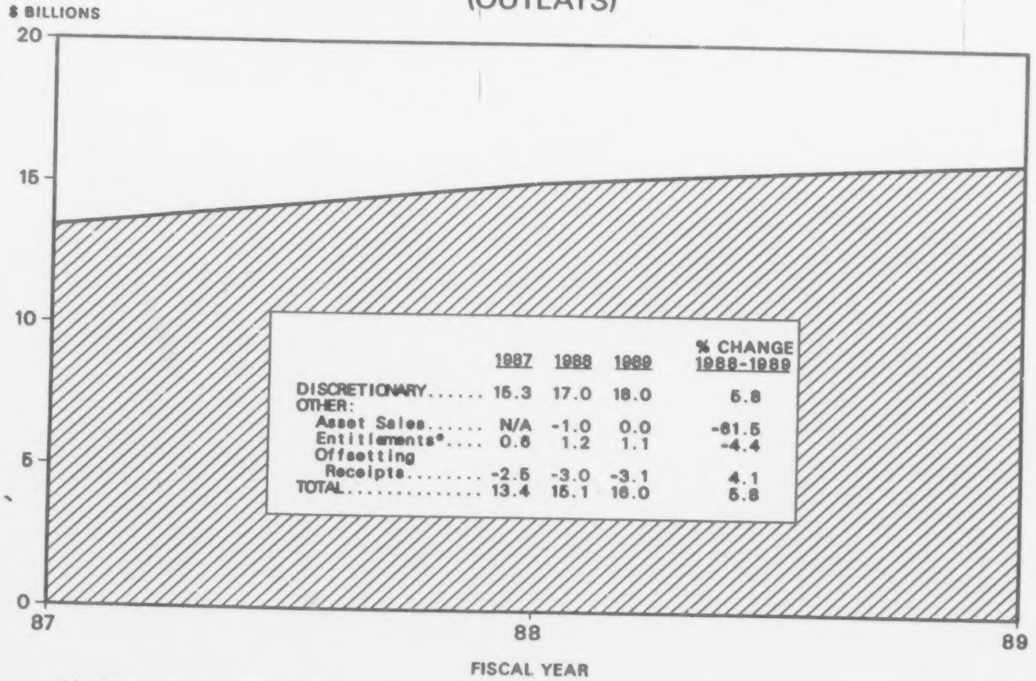
ENERGY - 270
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY.......	6.3	6.2	6.8	9.7
OTHER:				
Asset Sales.......	N/A	-2.0	-2.1	6.2
Entitlements*.....	0.7	1.5	1.6	6.9
Offsetting Receipts.........	-2.9	-3.0	-3.3	6.7
TOTAL...............	4.1	2.7	3.1	12.8

* Includes other mandatory programs.

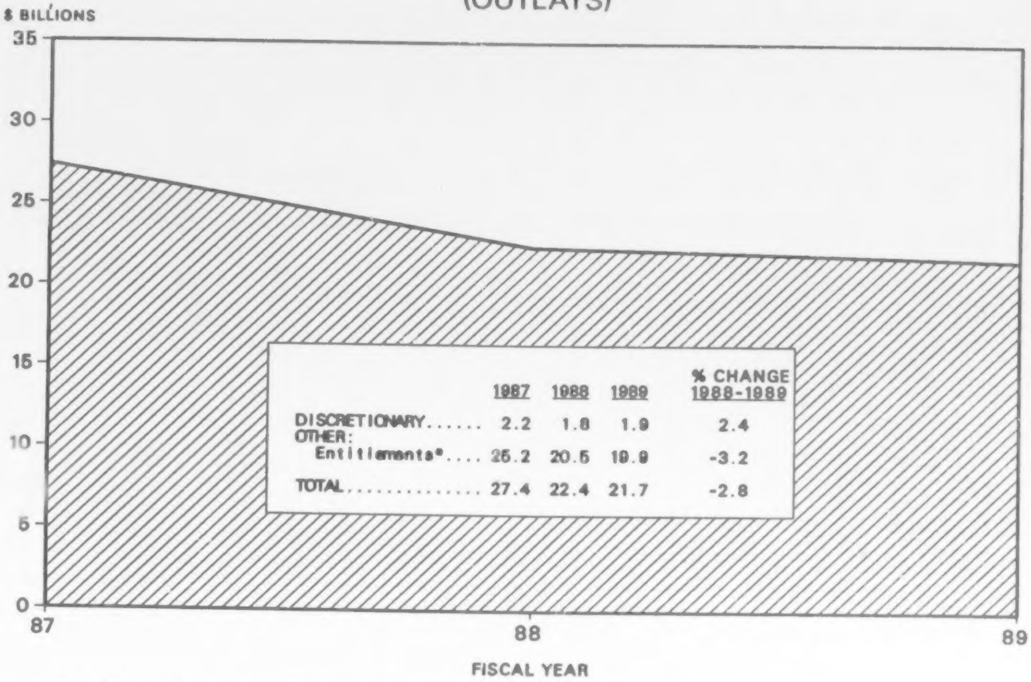
NATURAL RESOURCES AND ENVIRONMENT - 300
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	15.3	17.0	18.0	5.8
OTHER:				
Asset Sales......	N/A	-1.0	0.0	-61.5
Entitlements*....	0.6	1.2	1.1	-4.4
Offsetting Receipts........	-2.5	-3.0	-3.1	4.1
TOTAL..............	13.4	15.1	16.0	5.8

* Includes other mandatory programs.

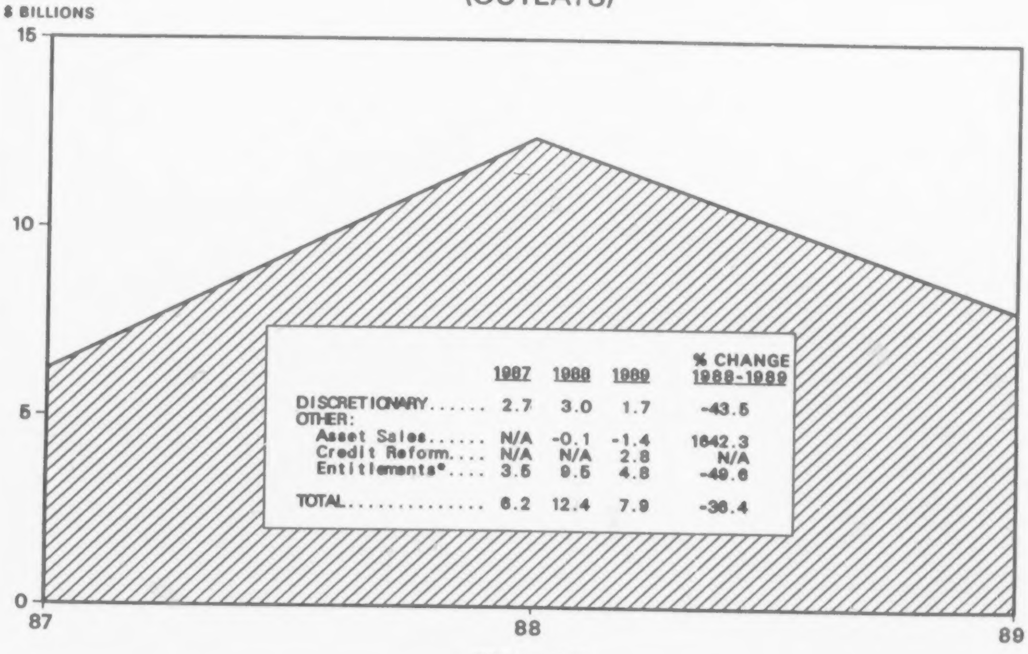
AGRICULTURE - 350
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY.......	2.2	1.8	1.9	2.4
OTHER:				
Entitlements*....	25.2	20.5	19.8	-3.2
TOTAL...............	27.4	22.4	21.7	-2.8

* Includes other mandatory programs and offsetting receipts.

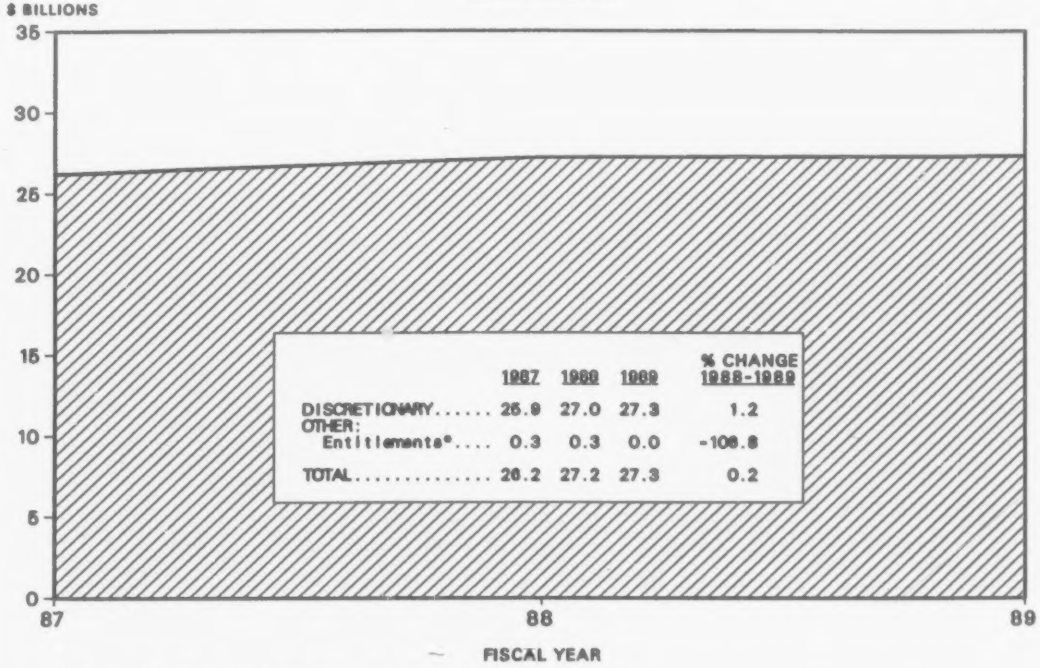
COMMERCE AND HOUSING CREDIT - 370
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	2.7	3.0	1.7	-43.5
OTHER:				
Asset Sales......	N/A	-0.1	-1.4	1642.3
Credit Reform....	N/A	N/A	2.8	N/A
Entitlements*....	3.5	9.5	4.8	-49.6
TOTAL..............	6.2	12.4	7.9	-36.4

* Includes other mandatory programs and offsetting receipts.

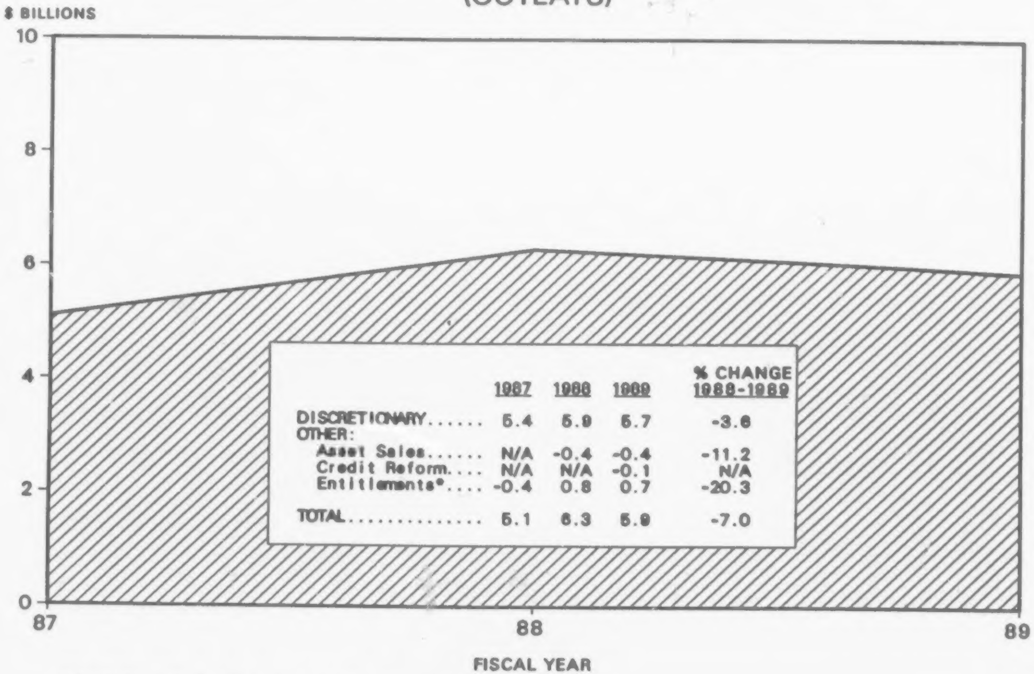
TRANSPORTATION - 400
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	25.9	27.0	27.3	1.2
OTHER:				
Entitlements*....	0.3	0.3	0.0	-106.8
TOTAL..............	26.2	27.2	27.3	0.2

* Includes other mandatory programs and offsetting receipts.

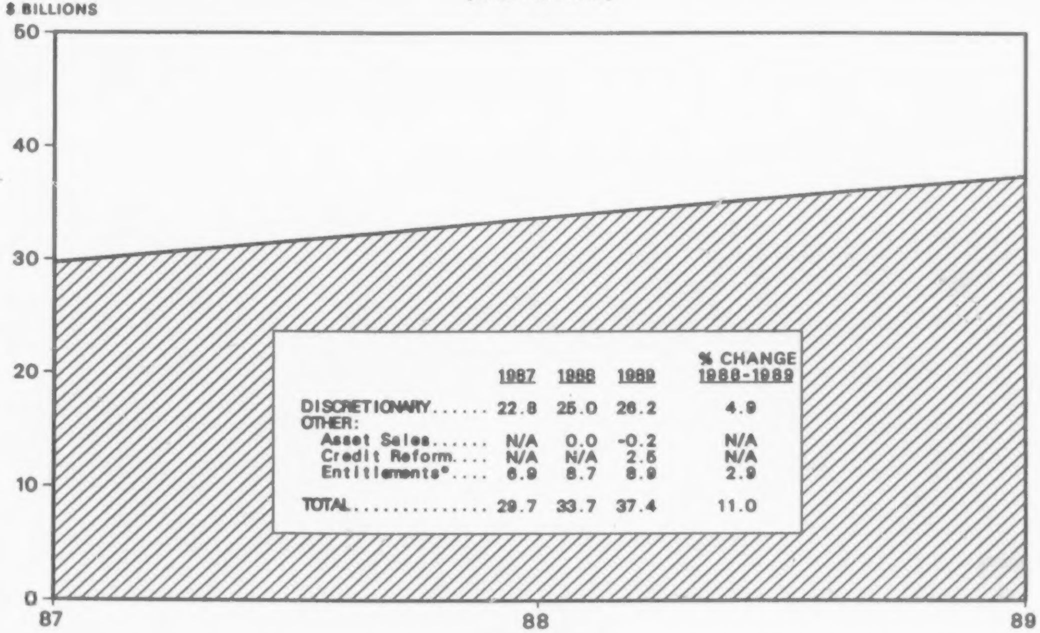
COMMUNITY AND REGIONAL DEVELOPMENT - 450
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY.......	5.4	5.9	5.7	-3.6
OTHER:				
Asset Sales.......	N/A	-0.4	-0.4	-11.2
Credit Reform....	N/A	N/A	-0.1	N/A
Entitlements*....	-0.4	0.8	0.7	-20.3
TOTAL.................	5.1	6.3	5.9	-7.0

* Includes other mandatory programs and offsetting receipts.

EDUCATION, TRAINING, EMPLOYMENT, AND SOCIAL SERVICE - 500
(OUTLAYS)

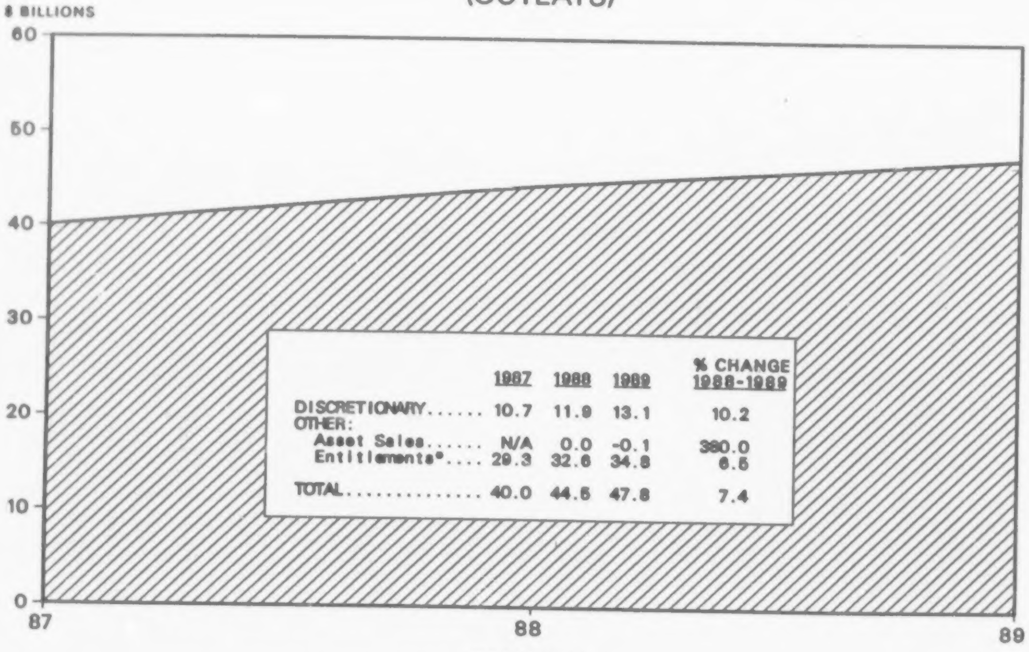


	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY.......	22.8	25.0	26.2	4.9
OTHER:				
Asset Sales.......	N/A	0.0	-0.2	N/A
Credit Reform....	N/A	N/A	2.5	N/A
Entitlements*....	6.9	8.7	8.9	2.9
TOTAL...............	29.7	33.7	37.4	11.0

FISCAL YEAR

* Includes other mandatory programs and offsetting receipts.

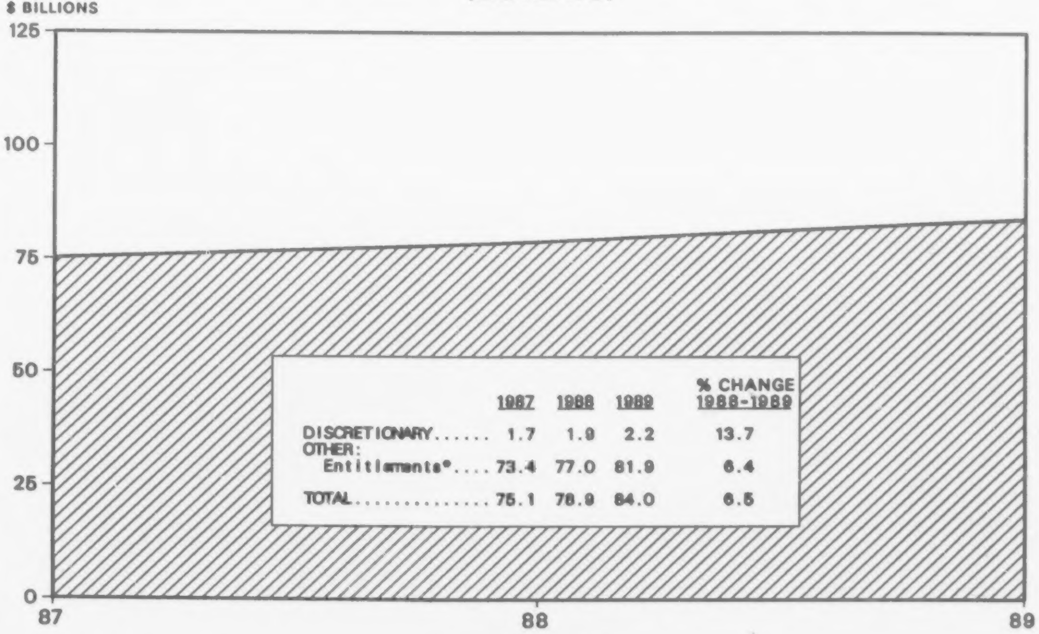
HEALTH - 550
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	10.7	11.9	13.1	10.2
OTHER:				
Asset Sales......	N/A	0.0	-0.1	380.0
Entitlements*....	29.3	32.6	34.8	6.5
TOTAL..............	40.0	44.5	47.8	7.4

* Includes other mandatory programs and offsetting receipts.

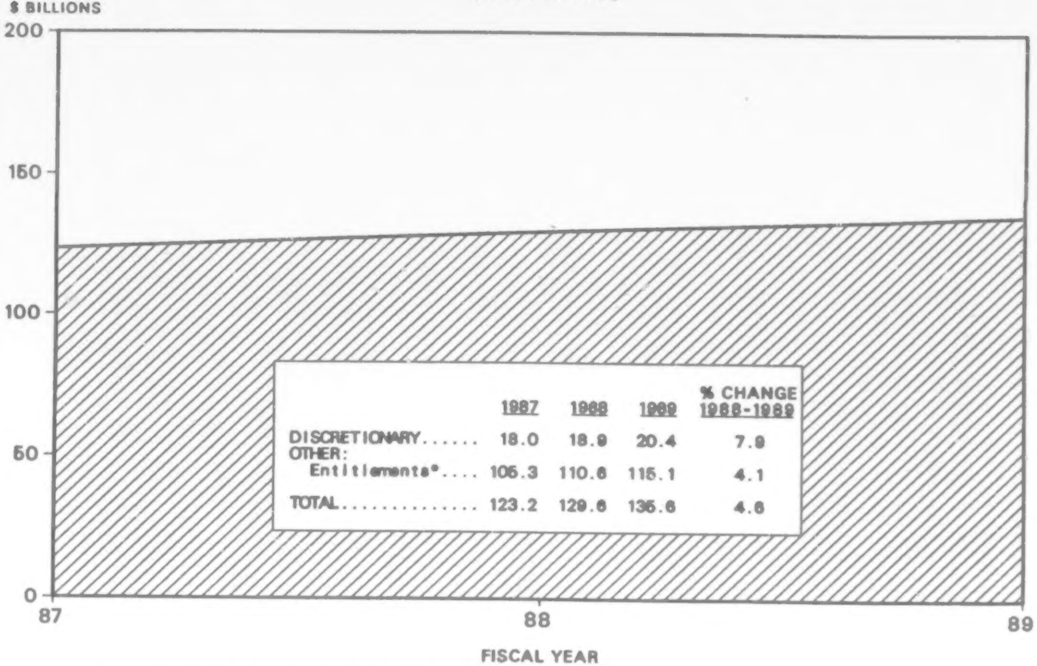
MEDICARE - 570
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	1.7	1.9	2.2	13.7
OTHER:				
Entitlements*....	73.4	77.0	81.9	6.4
TOTAL..............	75.1	78.9	84.0	6.5

* Includes other mandatory programs and offsetting receipts.

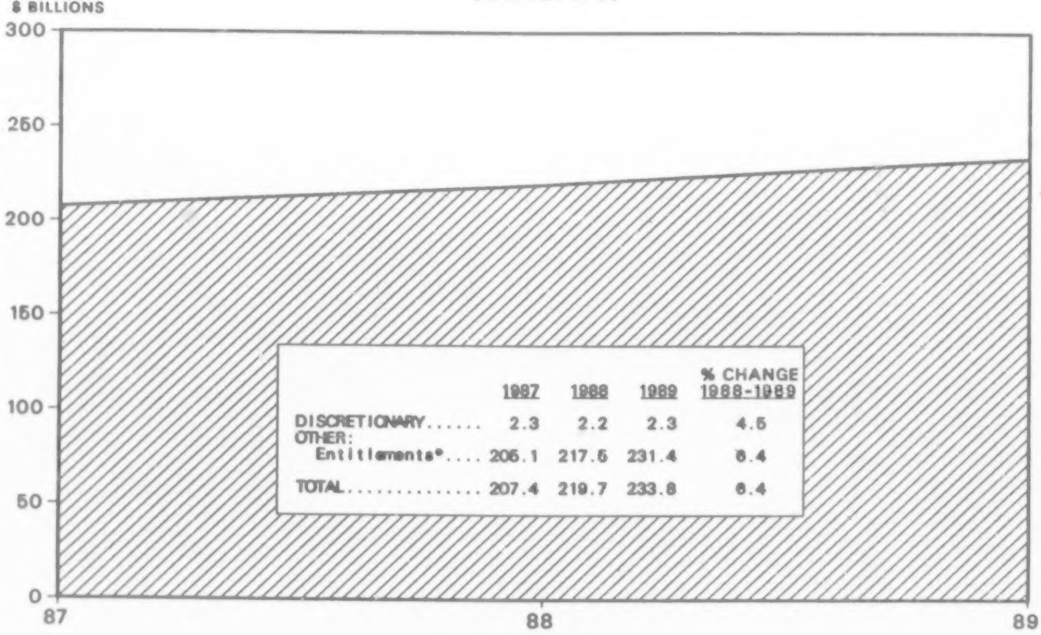
INCOME SECURITY - 600
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	18.0	18.9	20.4	7.9
OTHER:				
Entitlements*....	106.3	110.6	115.1	4.1
TOTAL..............	123.2	129.6	135.6	4.6

* Includes other mandatory programs and offsetting receipts.

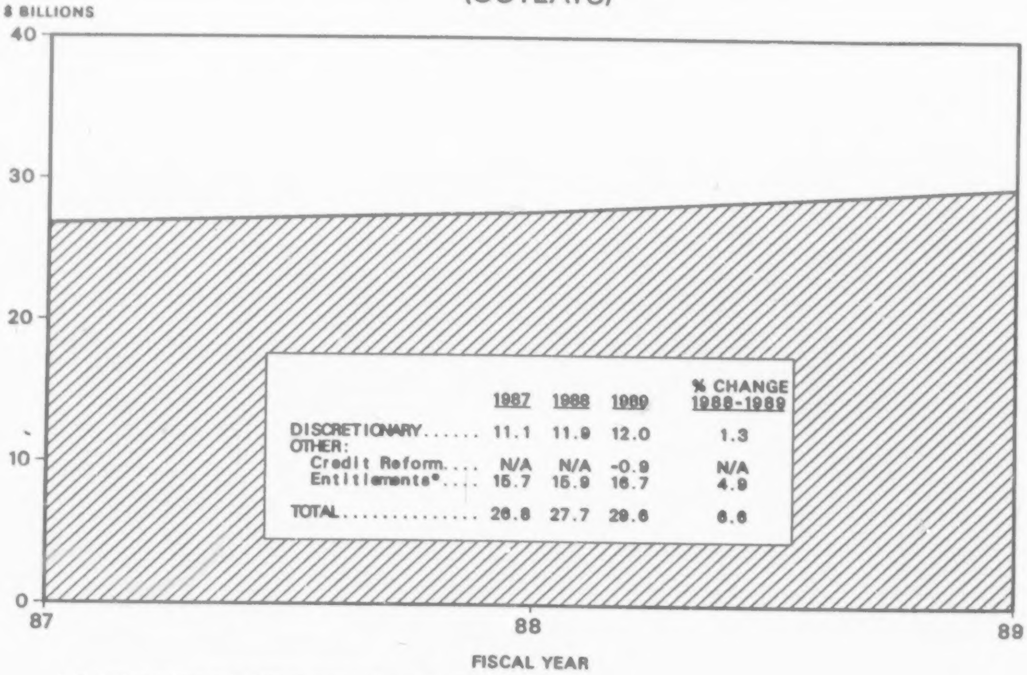
SOCIAL SECURITY - 650
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	2.3	2.2	2.3	4.5
OTHER:				
Entitlements*....	206.1	217.5	231.4	6.4
TOTAL..............	207.4	219.7	233.8	6.4

* Includes other mandatory programs and offsetting receipts.

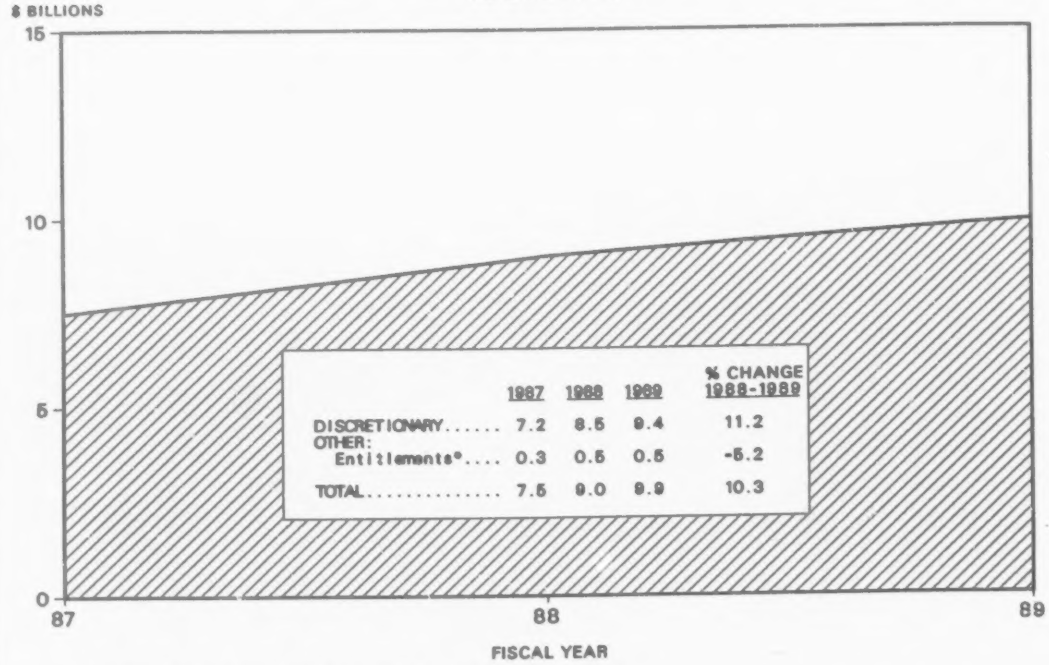
VETERANS BENEFITS AND SERVICES - 700
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	11.1	11.9	12.0	1.3
OTHER:				
Credit Reform....	N/A	N/A	-0.9	N/A
Entitlements*....	15.7	15.9	16.7	4.9
TOTAL..............	26.8	27.7	29.6	6.6

* Includes other mandatory programs and offsetting receipts.

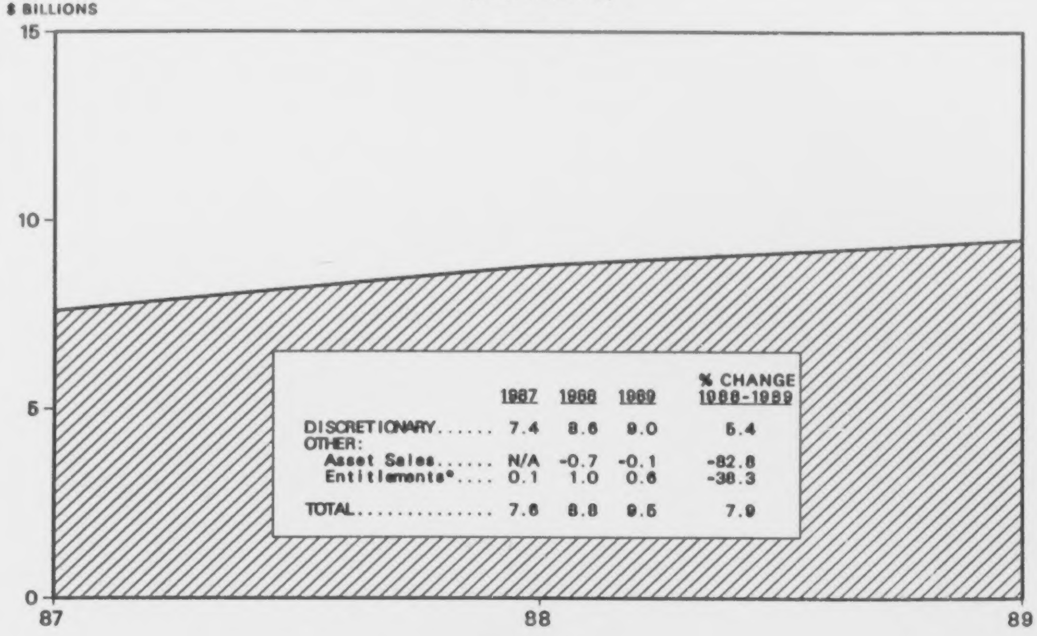
ADMINISTRATION OF JUSTICE - 750
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	7.2	8.5	9.4	11.2
OTHER:				
Entitlements*....	0.3	0.5	0.5	-5.2
TOTAL..............	7.5	9.0	9.9	10.3

* Includes other mandatory programs and offsetting receipts.

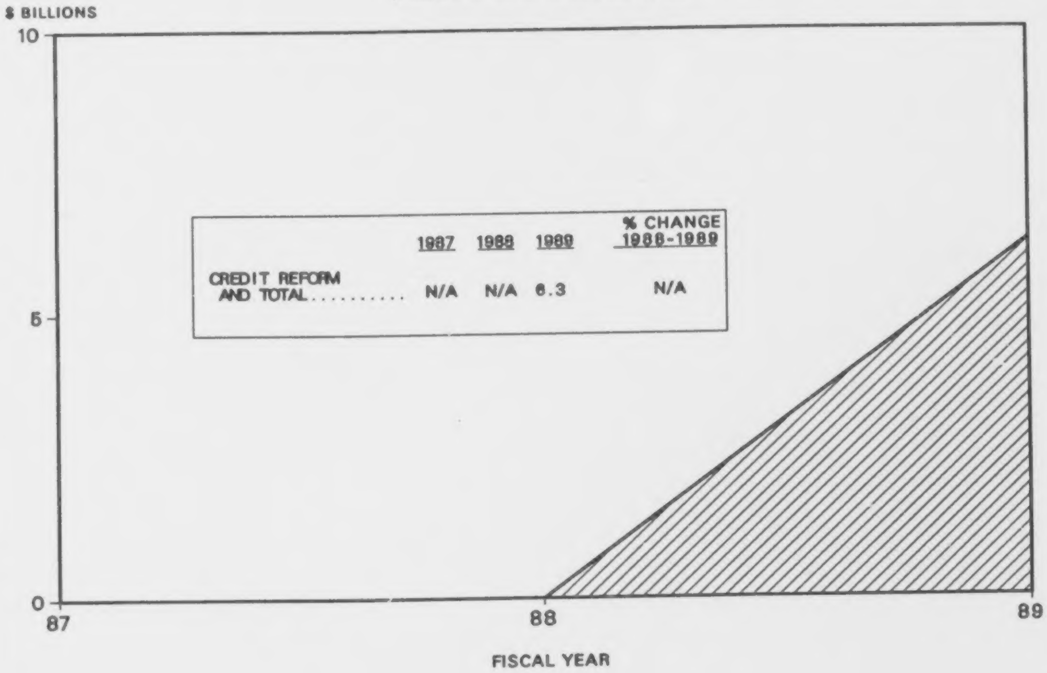
GENERAL GOVERNMENT - 800
(OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY......	7.4	8.6	9.0	5.4
OTHER:				
Asset Sales......	N/A	-0.7	-0.1	-82.8
Entitlements*....	0.1	1.0	0.6	-38.3
TOTAL..............	7.6	8.8	9.5	7.9

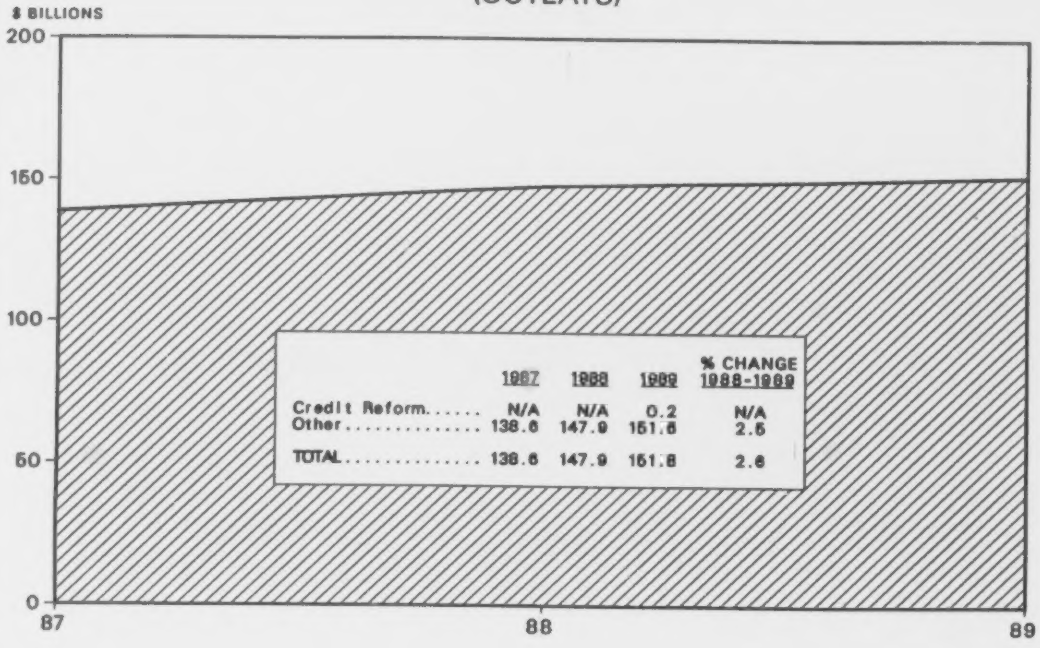
* Includes other mandatory programs and offsetting receipts.

CENTRAL FEDERAL CREDIT ACTIVITIES - 870
(NEGATIVE OUTLAYS)



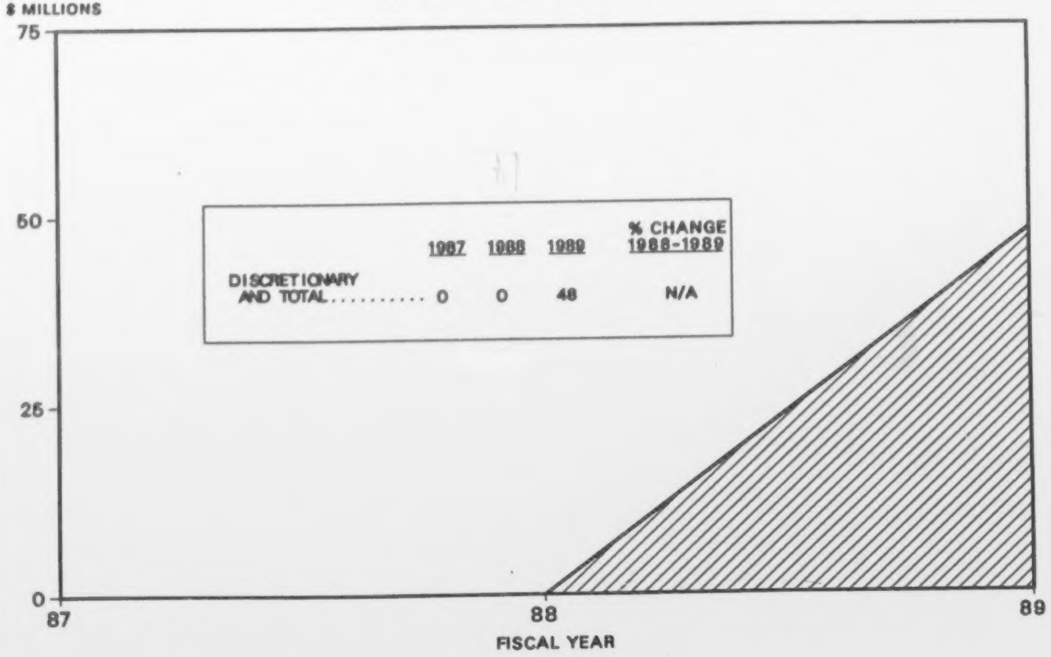
	1987	1988	1989	% CHANGE 1988-1989
CREDIT REFORM AND TOTAL..........	N/A	N/A	6.3	N/A

NET INTEREST - 900
(OUTLAYS)



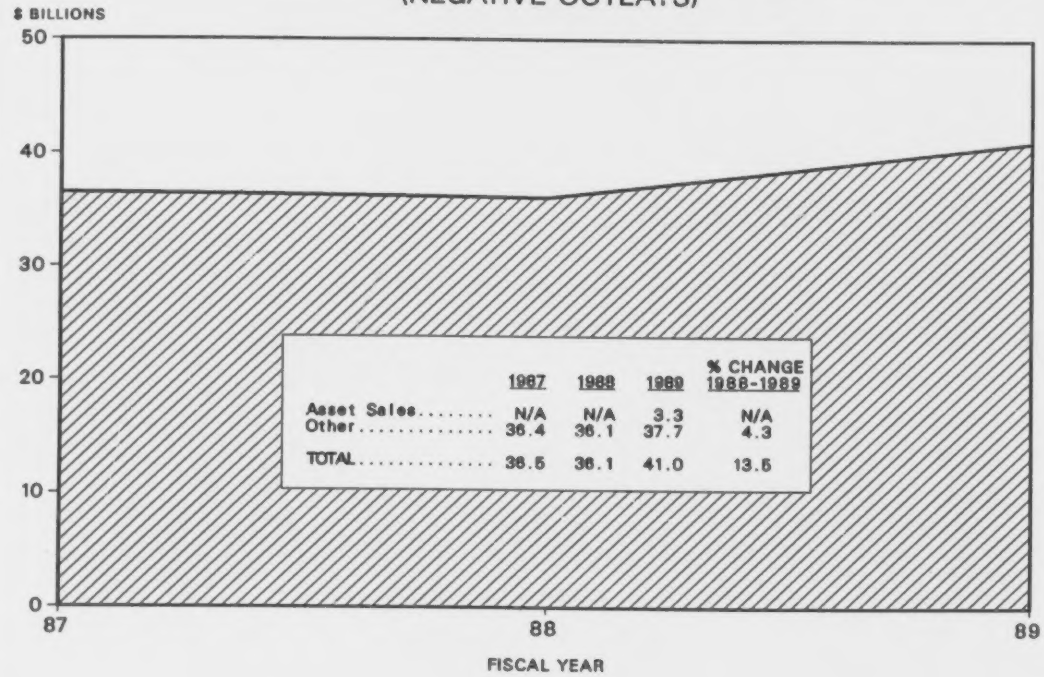
	1987	1988	1989	% CHANGE 1988-1989
Credit Reform......	N/A	N/A	0.2	N/A
Other...............	138.6	147.9	151.6	2.5
TOTAL...............	138.6	147.9	151.8	2.6

ALLOWANCES - 920
(NEGATIVE OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
DISCRETIONARY AND TOTAL...........	0	0	48	N/A

UNDISTRIBUTED OFFSETTING RECEIPTS - 950
(NEGATIVE OUTLAYS)



	1987	1988	1989	% CHANGE 1988-1989
Asset Sales.........	N/A	N/A	3.3	N/A
Other...............	36.4	36.1	37.7	4.3
TOTAL...............	36.5	36.1	41.0	13.5

Chairman CHILES. Now, we will go by the early bird rule today, and I will waive the opening round.

Senator Riegle, why not just go ahead and start?

Senator RIEGLE. Thank you, Mr. Chairman.

I would like to begin by referring to a couple of comments that are in the national newspapers today as they have begun the process of assessing this budget, just as we here are also doing.

In the Wall Street Journal today, the lead story is entitled: "Reagan's budget puts tough deficit cutting in lap of his successor. Fiscal 1989 gap of $129.5 million makes rosy assumptions," and it goes on to say that the budget does not look very realistic in terms of being able to actually achieve those numbers.

The New York Times has a viewpoint similar to the Wall Street Journal. In their headline they say, "Deficits fill a vacuum; election year surrender of responsibility is seen in budget."

Let me refer also to an analysis that was done yesterday in an editorial in the Washington Post. It says, "The Congressional Budget Office says in a new report that the surpluses in the trust funds are growing quite substantially"—the social security trust fund, highway trust fund and so forth—and that those trust fund surpluses, as the chairman earlier said, are being used to hide the true size of the operating deficit in the direct Federal budget. And according to the statistics, the trust fund surplus this year is estimated to be $97 billion. Is that a correct figure?

Mr. MILLER. The trust fund for social security is not anything like that. It is about——

Senator RIEGLE. No, but I am asking you what the trust fund surplus is for all the trust funds for the coming year.

Mr. MILLER. I do not know the figure.

Senator RIEGLE. Would you know what that figure is?

Mr. MILLER. $97 billion sounds awfully high to me. We will get that information for you.

Senator RIEGLE. I would like somebody in your group to provide that number now, if they can, because it is in the range of $97 billion. I think that is the accurate figure. Can we just pause for a minute? Will somebody in that group of aides come up with a figure? All trust funds.

Mr. MILLER. I presume since you are measuring—when you are talking about a yearly deficit, that you are talking about trust fund surplus for this year, not the total amount in trust fund.

Senator RIEGLE. No; The number that apparently you have constructed in one of your documents here, which is——

Mr. MILLER. Can you direct me to the document?

Senator RIEGLE. It is special analysis C, and the page number is C-5. And you show a trust fund surplus over in the 1989 estimate of roughly $67.4 billion. So you would be presenting here a number that is different—but still enormous—from the estimate in yesterday's editorial of $97 billion.

But the cold fact is, whether one argues that it's $67 billion, which is the number that you have given us, or it is a higher figure, that number tends to hide the true size of the operating deficit. That is really what I am getting at.

My concern is that the true operating deficit in the general accounts of the Federal budget is over $200 billion this year. How do you justify that? How do you justify asking for a $129 billion deficit or—if you take out these trust fund surpluses—actually asking for a deficit that is about $200 billion. How do you justify asking for that much deficit this year?

Mr. MILLER. First, Senator Riegle, we did one thing. We carried out the agreement. If the agreement was wrong, you need to talk to your colleagues, I think, who negotiated that agreement, the leadership of the Congress who negotiated that agreement. We battled mightily in that negotiation. Some wanted to reduce the deficit one way; some wanted to reduce the deficit another way. We struggled for 20 days and 20 nights——

Chairman CHILES. Dr. Miller, I was one of the people there. I do not remember reading anything in the agreement that said either the President or the Congress could not do more. Am I wrong?

Mr. MILLER. We did not interpret it that way.

Chairman CHILES. You did not?

Mr. MILLER. We interpreted it as to carry out this agreement——

Chairman CHILES. That you had to spend all this money?

Mr. MILLER. That we had to produce a budget that met those numbers. I have a copy of the agreement and the writeup here, but that was absolutely our understanding.

Senator RIEGLE. Well, the problem here is, if you add up the deficits——

Chairman CHILES. You did not seem to let that bother you when you put in $7 billion more in asset sales.

Mr. MILLER. No; because in the discussions, the clear understanding, my recollection and I think the recollection of other people was that the $3.5 billion in asset sales called for in 1989 were a minimum not a maximum.

Chairman CHILES. Oh, the asset sales were a minimum and not a maximum.

Mr. MILLER. That is right.

Chairman CHILES. But everything else was a minimum and a maximum.

Mr. MILLER. No; that was our discussion during the sessions. And I think if we had a transcript of that, that would clearly be reflected.

If I look here on the piece of paper that was typed up by members of the congressional staff and circulated, it said in Item No. 7, "Agreed upon discretionary spending levels are as follows," and they are the same numbers as contained on Page 8 of the highlights package here. That was the agreement.

In fact, Mr. Chairman, I have no doubt in my mind whatsoever that if the President had proposed a budget that had not met those figures in a good-faith effort, many members of Congress would have claimed that the President had violated the budget agreement.

Senator RIEGLE. Mr. Chairman, if I could just finish my observation here. I know my time is up.

When one looks at a chart—I do not have a large chart that I can show—but this chart shows our increases in the Federal debt over the last several years. It demonstrates in your own data—this is drawn from your data—that in 1981 our Federal debt was about $1 trillion dollars, as you know. Our Federal debt at the end of this year is going to be $2.5 trillion. That is an astonishing change in circumstance in terms of adding up all of this massive additional debt.

It seems to me that we should not fool anybody about what the President's request is. You are asking for a large addition to that debt, if everything works perfectly. If these optimistic economic assumptions work out, you are asking for a new addition to the Federal debt of $129 billion. But, in fact, if you take away these trust fund surpluses, the real increase in debt that you are asking for is about $200 billion.

Now, that is going to be $200 billion on top of all of this other red ink. I frankly do not see how our financial structure is going to continue to support the weight of all of that Federal debt. Of course, in addition to that, we have the international debt that is increasing our debtor nation status because of the trade problem. We do not have a trade strategy in this country.

But I think some time today you have got to give some clear answer as to how the administration justifies adding on, at a minimum, another $130 billion of new national debt and probably a figure that is actually closer to $200 billion. And I do not think you have done that yet.

Thank you, Mr. Chairman.

Mr. MILLER. Well, Mr. Chairman, could I respond by saying, repeating that we carried out the budget agreement that was orchestrated, concluded last November. That is what we have done, and we have carried it out to the letter.

Second, the national debt held by the public has increased from 1981. It was at a level of 26.6 percent of the gross national product, and our estimate for 1988 is that it will be 43 percent. It will actually decline as a proportion of gross national product from here on out, according to the President's budget, which, again, reflects the agreement reached last November.

I might point out that while this is a very heavy burden, it is not a burden that necessarily means that we cannot move forward. I would just point out that the longest peacetime expansion prior to the present one, which is into its 63rd month, was one in which in the early 1960s when the debt, national debt held in public hands as a proportion of gross national product exceeded the level that we have today. I do not want to whitewash the deficit. I do not want to defend the deficit. I do not want to whitewash the national debt or defend the national debt. We need to work on it. But it is not an impossible situation.

Senator RIEGLE. Well, my time is up. Thank you, Mr. Chairman.

Chairman CHILES. I really think we need to move on. Senator Domenici.

Senator DOMENICI. I yield to Senator Grassley.

Chairman CHILES. Senator Grassley.

Senator GRASSLEY. Thank you very much, Senator Domenici and Mr. Chairman.

First of all, Mr. Miller, I want to commend you for proposing a budget——

Chairman CHILES. I may have had this wrong. I thought that——

Senator GRASSLEY. No; I was here ahead of him.

Senator NICKLES. It is unusual but it is true.

Senator GRASSLEY. Now, may my time start right now?

Chairman CHILES. Yes.

Senator GRASSLEY. Thank you.

I hope that you get a lot of commendation today for proposing a budget agreement that conforms with the summit compromise that was reached last fall. It is my hope, too, that since we are in this mode of the compromise that we take advantage of the cooperation that has been exhibited, and maybe we can expedite a budget package to the floor maybe without having the number of hearings that we have had in the past.

Now, while indicating my optimism for an expedited budget this year, I would like to raise a troubling thought, which you as budget director, as well as this committee, all have to be very concerned about. In doing this, I want to quote from our CBO's economic and budget outlook. The context of this quote, Mr. Miller, is a possible sequester in October of 9 percent in defense and 13 percent in nondefense programs if it turns out that the 1989 deficit estimates become higher in the August snapshot. This is a quote from Page XVII summary.

"These cuts could be avoided if OMB's estimate of the deficit were within the $10 billion target." That is, less than $146 billion. Continuing to quote, "While using more favorable economic assumptions could reduce the projected deficit to that level, relying on this approach to get through the 1989 budget year would make the 1990 deficit reduction task that much harder. Taking no action this year beyond that required by the budget summit would leave the 1990 deficit around $160 billion, according to CBO's current estimates. With a 1990 deficit target of $100 billion, the excess deficit would be $60 billion, almost double the amount of the deficit reduction achieved in the first year of the summit."

Now, let us suppose that you were compelled because of updated economic information to raise your deficit estimates in August for the fiscal year 1989 budget. And admittedly, I am speaking in terms of the hypothetical here, but let us say that the new estimate might be $176 billion as projected by CBO, or even $166 billion as projected by the consensus forecast. That would be about $20 to $30 billion over the Gramm-Rudman targets.

If that were to happen, the administration and the Congress would be faced with several choices. First, we could choose to uphold the summit agreement regardless of the deficit implications. Second, we could reopen the summit agreement and establish a list of cuts or priorities, or even a tax increase, I suppose. And third, to meet Gramm-Rudman targets, we could allow the sequester to take effect.

So my question to you as director of OMB is: Which would you advise the President to support?

Mr. MILLER. Well, Senator Grassley, it is a hypothetical.

Senator GRASSLEY. But do we not have to be prepared for——

Mr. MILLER. Let me just say, number one, I seldom say publicly what I would tell the President, much less what I do tell the President. Second, it is a hypothetical, and I would have to see what developed. Third, let me just make a technical point. If the deficit, as determined under the Gramm-Rudman-Hollings rules with the algorithm as I described turned out to be $176 billion, then you would not sequester $30 billion. You would sequester $40 billion because you have to come down all the way to $136 billion, not to $146 billion. If you are over the $146 billion trigger, you have to then come down to $136 billion. So you are talking about $40 billion or $30 billion rather than $30 billion or $20 billion.

Obviously, if next fall we determine, because of the deterioration in the economy or something, that our estimate is incorrect and we revise the estimate, and that estimate with the algorithm goes over $146 billion, that would mean a sequester. If that were to be the case, I think surely the President and the leaders of Congress should sit down and resolve some way of avoiding a sequester. A sequester or an across-the-board hatchet approach is not in anyone's interest.

But let me just say again we have reason to believe that our estimates, rather than CBO's, are appropriate. Last year, we came here and I sat at this very area—not quite so surrounded, perhaps—and I was told that our estimates were far too optimistic; that CBO's estimates, which were more pessimistic, were appropriate; that the blue chip estimates, which were more pessimistic, were the appropriate estimates to rely upon.

But, in fact, our estimates were not optimistic enough. The economy performed better than we had estimated. We estimated last year a real gross national product percentage increase at 3.2 percent, CBO at 3 percent, and blue chip at 2.8 percent. But the actual increase was 3.8 percent. We used the same methodology this year. We believe that our projections are appropriate, and we have reason to believe that if the Congress passes the President's budget or otherwise complies with the bipartisan budget agreement, that we will avoid a sequester and we will get the deficit down.

Senator GRASSLEY. I think during your long answer you did answer my question, and that is that you would recommend further additional cuts.

Mr. MILLER. To avoid a sequester, yes.

Senator GRASSLEY. Would that involve any sort of a tax increase, which it could as part of it?

Mr. MILLER. Well, I think it would not be particularly helpful to get into speculating on what it would be. I would presume that the President would be opposed to a tax increase.

Senator GRASSLEY. I am not begging for you to say you will have a tax increase.

Mr. MILLER. I doubt that President Reagan would be inclined to——

Senator GRASSLEY. Where would you favor making——

Chairman CHILES. You are saying, Dr. Miller that you--excuse me.

Senator GRASSLEY. Well, I wanted to find out where he might suggest additional cuts if that were the case.

Mr. Miller.

Mr. MILLER. Well, Senator Grassley, that is hypothetical. I think it is most useful for us to focus on this agreement and carrying out this agreement and——

Senator GRASSLEY. I have already complimented you for that, and I am not detracting from it. But I think that you pointed out maybe last year your projections were a little more closer than others. But generally speaking, just generally speaking over the last several years that I have been on this committee, the administration's projections have been much rosier than they should be.

Mr. Miller. Mr. Chairman, in the last 4 years, we underestimated twice and we overestimated twice.

Chairman Chiles. Now, when you say underestimated and overestimated, you are talking about the growth. But you also estimated what the deficit was going to be. And as I remember your estimate of the deficit, it was $107 billion.

Mr. Miller. The President's budget——

Chairman Chiles. You were not over-optimistic on that, were you?

Mr. Miller. The President's budget, which was not enacted by the Congress, Mr. Chairman, had a deficit of $108 billion, correct, for fiscal year 1988.

Chairman Chiles. All right. Senator Sanford.

Senator Sanford. Thank you, Mr. Chairman. I have a few remarks and then maybe one question. I have been looking forward to this hearing ever since the State of the Union speech when the President held the Congress up to ill-deserved ridicule on national television. Because everyone there, those who applauded and those who grimaced, knew full well that the President, by his refusal to sit down with the congressional committee chairmen until he was forced to at the last moment by the Wall Street problems, was the primary cause of his 14-pound continuing resolution.

Then everyone there applauded his call to get serious about our getting our financial accounts in order. When he proclaimed that the budget process has broken down, needs a drastic overhaul, I applauded but I was applauding to irony.

We do need to reform the budget process, which the President once again called for, and we need to reform it from the first step to the last. The first step in the budget process is the President's budget which you brought over here today. This budget is not balanced; it is not even in conformity with Gramm-Rudman-Hollings except by resort to fictions. The President in his State of the Union message called once again for us to pass a constitutional amendment that mandates a balanced budget and forces the Federal Government to live within its means. Curiously, he included it again in his budget message that came with this budget.

Now, was that called for in deceit or was it called for in jest or was it sincere? Now, if it was sincere, the President has that power to show us how to balance this budget right now. Balancing the budget is in the complete control of the President right now. So let us let him make believe that he is required by the Constitution to balance the budget, and then do it.

I would be in favor of sending this budget back to him, but there is no question that I want to make the point that the President's budget is the first step. It is the most important step, and it is the first place for reform to start. And it is absolutely true—just look at history—that the only way we can have a balanced budget is for the President, any President, to first propose a balanced budget.

I am always reluctant to come to hasty judgments, but it certainly was apparent to me last year, the first time I sat in this position, and it is apparent again this year that the President is setting out to blame the Congress for deficits that are under his control. I am reluctant to say it, but it seems to me that this budget is just another ploy in a game of deceitful politics.

Now, I know there's no procedure for sending a deficit budget back to the President for additional work, but in any event, I am going to give you back my copy before you leave here, because I want the record to show that I object to the kind of doublespeak we have been getting on budgets and balanced budgets. I think the President could work on this and get it to meet his standard, using his words 3 weeks ago in his State of the Union message, "the simple—simple", he said—"but frustrating problems of making expenses match revenue."

Now, I am an expert on what George Washington said in his farewell speech, and he said, "Cherish public credit. Avoid the accumulation of debt, not ungenerously throwing upon posterity the burden which we ourselves ought to bear." It is still not too late for President Reagan's farewell budget to be a ringing reaffirmation of American fiscal responsibility as he leads the way with a balanced budget.

My simple question is, if we had a constitutional amendment, would President Reagan balance this budget?

Mr. **Miller**. Let me respond to that statement in a couple of ways. Number one, this budget is a reflection of the bipartisan agreement——

Senator **Sanford**. Then is it not too bad we need a bipartisan agreement. We ought to have had a balanced budget last year.

Mr. **Miller**. Senator, if I might, let me respond to your points. Number one, this budget is a reflection of the bipartisan agreement concluded by the leaders of Congress and the President last November.

Number two, the President cannot spend a dime that Congress does not appropriate.

Number three—I will try to be quick—I think it would be a mistake to try to eliminate the deficit overnight. Frankly, if the President were to propose a budget that did eliminate the deficit overnight, I can imagine the turmoil that would exist in Congress. And I do not believe for a minute that Congress would take the necessary steps to increase taxes in dramatic degrees and cut spending in dramatic fashion that would eliminate the deficit overnight.

Finally, I would point out that the President's advocacy of a balanced budget amendment has asked for the balanced budget amendment to kick in in the year in which Congress has passed Gramm-Rudman-Hollings to balance the budget. And if you will look at the President's budget, under Gramm-Rudman-Hollings, the budget is supposed to be balanced by 1993. This budget of the President's would leave a $23 billion deficit in 1993. We need to tilt that line down a little bit more, but the reason the President did not include the necessary steps to bend that deficit line down just a bit is because it is his conclusion that some in Congress, if he were to make those changes for 1990 and the out-years, would argue that he had violated the budget agreement. And he did not want that.

Senator **Sanford**. Well, I quite agree, and I do not really mean to put you in an embarrassing position. But President Reagan has had 7 years. I do not disagree that we have got to stick with Gramm-Rudman.

I object and want to make the point that I think this constant suggestion that we could have a balanced budget if only Congress would give us a constitutional amendment ought to come to an end.

Thank you, Mr. Chairman.

Chairman Chiles. Thank you, Senator. Senator Nickles.

Senator Nickles. Mr. Chairman, thank you very much.

Mr. Miller, just a couple of quick questions. You estimate the deficit for the year that we are in right now, fiscal year 1988, would be $146 billion; is that correct?

Mr. Miller. No, sir, we estimate the deficit to be $129.5 billion.

Senator Nickles. No; I am talking about 1988.

Mr. Miller. Oh, excuse me, for 1988 that is the neighborhood.

Senator Nickles. Also I track these monthly Treasury reports, and it shows that the deficit for the end of the fiscal year, the first quarter, was $80 billion, which alarmed me. That is $15 billion more than it was the previous year, as far as year to date, for the end of the first 3 months.

We have not gotten the January figures yet. They were supposed to be out today. I was hoping we would get them before the hearing, but we have not gotten them.

I am really concerned. If it is $80 billion at the end of the first quarter, and you are estimating it is going to be $146, we are already halfway there, in only one-fourth of the year.

So does that 146 look pretty solid?

Mr. Miller. Yes; I think it does. Keep in mind that there was an anomaly in December. There was a payment of two social security checks, which accounted for a good deal of the outlays.

A note just handed to me said $18 billion; I thought it was a larger number.

Senator Nickles. So it was low in December; hopefully it will be better in January and so on?

Mr. Miller. That's right.

Senator Nickles. Let me ask you another question, because this is right on the same line.

I notice in your report that individual income taxes, between 1987 and 1988, are flat. And then between 1988 and 1989 there is an increase of about $19 billion.

But between the year 1986 and 1987, which I have brought to the chairman's attention, we had a significant deficit reduction. You had an 11 percent increase in receipts on income taxes; I am talking about personal income taxes.

But between 1987 and 1988 it goes from $392 billion to $393 billion. In other words, there is no growth for personal income tax for the year that we are in. Why would that be?

Mr. Miller. Well, the reason is—maybe I misunderstood you. What we anticipate for the coming year from 1988 to 1989 is about the same increase in nominal GNP from which the Treasury receipts model is driven.

So even though the base is higher, the rate of growth that we assume for fiscal year 1989 is 2.4 percent against the rate of growth for—remember in 1987 the economy grew 3.8 percent.

And so the difference is reconciled because the rate of growth in the economy would be lower.

Senator NICKLES. Jim, what I am trying to point out is that between 1987 and 1988, the year that we are in right now, we just completed a good healthy year, as you mentioned, 3.8 percent, but total income receipts from individuals had no growth.

And that is going to cause us a problem in 1988, in the year that we are in right now.

Mr. MILLER. Could I get back to you on that? But these numbers, are reflected in the total estimates of the deficit for 1988, do incorporate all the numbers that we have seen.

Senator NICKLES. I know. But I was looking at 1986 to 1987, when we had a significant reduction in the deficit, mainly because spending was held down to 1.4 percent growth, which is a low growth rate. You had revenues growing at an astronomical rate—11 percent.

But the revenues between 1987 and 1988 on individuals were flat. You had a nice growth rate for corporate but you had no growth rate for individuals.

So as a result, I think if that is accurate, I think we are going to be in a bind for 1986.

A couple of other quick comments—I do not know how much time we have. You show zero income coming in from windfall profits tax for 1988 and 1989, is that correct?

Mr. MILLER. Yes; the windfall profits tax?

Senator NICKLES. Yes.

Mr. MILLER. Yes; the reason is that after we put all of our assumptions together and put this budget to bed in terms of the effects on receipts and outlays, it appears that the price of oil has fallen somewhat.

Even under the old assumptions it would be a very small amount of money. Our best judgment right now, given the price of oil and given how that would change our assumptions, is that the elimination of the windfall profits tax would not cost the government any receipts.

Now, let me say it again. The elimination of the windfall profits tax would not cost the government any receipts.

Senator NICKLES. I understand. Does the administration support repeal of the windfall profits tax?

Mr. MILLER. Yes, indeed, it does.

Senator NICKLES. One final question. There was an article in the Wall Street Journal where you talked about budgetary reform, and it talked about a procedure, and I am not that familiar with it, that the administration does have if they exercised somewhat of a quasi line item veto.

Have you reviewed that, considered using it? Are you familiar with it?

Mr. MILLER. We have looked at this issue; researched the issue. The Attorney General has looked at it. And at this point we are not—we have—the President has not made a determination to follow up on that. That is something under discussion.

But I would just mention to you the tax reform of 1986, which has had some phasing in. And, as you know, there was a cut in individual income tax rates.

But let me just say that total receipts for the first 3 months were at $204.9 billion, and our earlier calculation was 202.9, so total receipts are very much in the ballpark for the first quarter of 1988.

Senator **Nickles**. But for the year estimated in your budget, you show individual income taxes being, for 1987, 392, and for 1988, 393, which is——

Mr. **Miller**. But again, Senator, individual income tax rates were cut.

Senator **Nickles**. I know.

Mr. **Miller**. And so the incentive effect would not necessarily take place immediately. To the extent that individual income tax rates are cut, and this provides a stimulative effect, you do not necessarily expect it to occur so greatly and so immediately.

So the fact that total receipts from individual income tax are not estimated to go up is a reflection that, despite the fact the rate has been cut, there has been growth and some stimulative effects.

The totals for receipts overall are on track.

Senator **Nickles**. Thank you, Mr. Chairman.

Chairman **Chiles**. Senator Lautenberg.

Senator **Lautenberg**. Thank you, Mr. Chairman.

Mr. Miller, in your comments, you have confirmed that which we have heard and, read about, getting rid of mass transit supports, Amtrak. Of course, coming from the State that I do, that sent a chill through the air.

This country and its economy cannot do without a balanced, integrated, intermodal transportation system. If our policy ignores the transportation issues of any section or any region, the impact that is felt in those communities is obviously felt across the country.

It impairs the efficiency of our whole transportation network, and frankly weakens what I and many consider as the principal issue for us, coming into the next decade, and that is, how do we move people and goods at a reasonable rate as the economy and the country expand.

That kind of balanced policy is not what we see reflected in your proposal. We cannot just add money in one part of it, aviation, for instance, put more money in Coast Guard, which we agree is necessary as part of the drug interdiction program, and savage mass transit by $1.8 billion. And frankly I fail to see the logic in those proposals.

They seek to improve some parts of the system at the expense of the others. The results, if carried out, would mean more clogged highways, overcrowded airports, more urban congestion, and of course, more pollution.

And for many of our smaller communities, more isolation as well.

Why does the administration think that there is a national interest in modernizing, expanding interstate air passenger service, but no national interest in maintaining intercity rail passenger service?

I don't know whether you have stopped to look at what the result might be of travel, let's say in the Northeast corridor, as a good point of reference, if we were to reduce Amtrak or eliminate Amtrak service. I think we are talking about somewhere, 35 to 50 flights a day having to get into Washington National.

And I know, Mr. Miller, when you are not on Air Force One, you use commercial aviation. You know how difficult that gets to be. We bump into one another occasionally on that line.

Mr. **Miller**. We also rode Air Force One together.

Senator **Nickles**. That was nice. If I could have that for weekend commuting, I might not be so grave.

But on the very serious side, what do we do with the result of eliminating support for mass transit and Amtrak? Is there some magic wand that is going to be waved out there that says, OK, the highways will now be eight lanes, if people can tolerate that, and we will design new 1,000-person airplanes, or something of that nature?

How are we going to accommodate this?

Mr. **Miller**. Senator, let me respond to that. In the case of air transportation, we are spending money out of the trust fund to provide services to improve the infrastructure for air transportation.

In the case of mass transit, what we propose to do is to spend the 1 cent per gallon that was supposed to be earmarked for mass transit. That is what we are proposing to spend in the budget. We do not cut it below that.

Senator **Lautenberg**. You change the structure of appropriations.

Mr. **Miller**. Well, but we propose to spend that amount of money.

With respect to Amtrak, that is something that, as a matter of fact, I have looked into. I have written about it long before I came to government.

And it is a matter of fact that Amtrak, at least the kind of structure that presently exists, is extraordinarily inefficient. It is extraordinarily inefficient.

There are many instances where you could simply give vouchers to people who ride the trains and have them ride first class air service at a lot lower cost to the taxpayers.

You could even organize charter flights for people who ride the rails in order to avoid those costs that are imposed on the U.S. taxpayer.

So we have a proposal to cut off the subsidy to Amtrak. There is no ticket tax paid by Amtrak. There is no trust fund for Amtrak. It all comes right out of the pocket of the taxpayer.

And the idea would be to wean Amtrak off, and cause the operation to put together an efficient system. We believe that there would be an efficient system in the Northeast corridor, and perhaps a corridor system out on the West Coast, and possibly a hub and spoke operation out of Chicago.

Senator **Lautenberg**. You have looked at railroads, Amtrak in particular. And do you see anyway at all that communities that are left out now of air service would have a transportation contact to keep going?

Is it not a fact, Mr. Miller, that in country after country, intercity rail service is subsidized, very often in much larger proportions at the fare box than we see here?

Mr. **Miller**. Well, let me say a couple of things in that regard. First, the number of cities and small towns served by scheduled bus service is far larger than the number of small towns served by Amtrak.

And in fact, a major reason that some of these towns do not receive better bus service is because of the existence of subsidized rail service.

The third point is that it is true that in a number of countries, the intercity rail system is subsidized to a fairly hefty degree. But from what I understand—and I have not researched this lately—that their grids, their systems, are far more efficient than what we have here.

Our country is very different than most European countries. It is much more spread out. It has pockets of activity around the country that are different from the sort of end-to-end population centers continuum that we have in Europe, and even along the coast in Japan.

So the subsidies are there. They're much more efficient systems. And I think the comparison with the United States is not well taken.

Senator LAUTENBERG. Would you think it necessary to maintain the balance in our transportation system that we could get it by an increase in the gas tax, another penny or two? Is that something you think would be worth considering to preserve the rail network that we have got, the commuter service, the mass transit service that we are providing?

Mr. MILLER. No, sir, I do not.

Senator LAUTENBERG. So you are of the opinion that mass transit, and Amtrak, ought to stand on its own, because you know that $1.2 billion is not going to take care of it.

Mr. MILLER. I believe that Amtrak should stand on its own feet. And I think in mass transit the penny a gallon that Congress passed to go to mass transit should be the amount of money; not anything above that.

Chairman CHILES. Senator Danforth.

Senator DANFORTH. Mr. Miller, you have a chart in this book, Federal Investment Outlays.

SUMMARY OF FEDERAL INVESTMENT OUTLAYS

(In billions of dollars)

	1987	1988 estimate	1989 estimate
Physical investment:			
Direct:			
National defense	89.5	87.5	88.5
Nondefense	12.5	14.2	15.2
Subtotal, direct physical investment	102.1	101.7	103.7
Grants to State and local governments	23.8	25.1	24.9
Subtotal, physical investment	125.9	126.8	128.5
Conduct of research and development:			
National defense	37.1	36.5	39.8
Nondefense	16.2	18.1	19.8
Subtotal, conduct of research and development	53.3	54.6	59.6
Conduct of education and training:			
Direct	11.6	12.2	15.4
Grants to State and local government	12.3	13.4	14.1
Subtotal, conduct of education and training	23.9	25.6	29.5
Loans and financial investments	−2.4	−6.4	−1.2
Other (including commodity inventories) [1]	8.2	5.1	5.9
Total, Federal investment outlays	**208.9**	**205.7**	**222.3**
National defense	126.9	124.3	128.6
Nondefense	82.0	81.4	93.7

[1] Includes a small amount of outlays for private physical investment.

Mr. MILLER. What page?

Senator DANFORTH. 6c–2.

Mr. MILLER. Yes, sir.

Senator DANFORTH. Tell me, is there concern within the administration on the possible underinvestment by both the public sector and the private sector in the domestic side of our economy, taking the spending side with the effects of the 1986 tax bill.

Has there been any expression of concern within the administration that perhaps we are not investing sufficiently in the future?

Mr. MILLER. Well, let me say, the table there just reflects the public, Federal sector; not the State sector; not the private sector.

Senator DANFORTH. Well, it does reflect State I think, does it not? I am sorry, it reflects grants to state.

Mr. MILLER. Yes; it includes grants to States. And let me say inherently it is very difficult to track all of this because you do not know what States will do with some of these funds. So you have to just make a good estimate.

Let me say that within the administration there is concern over that. There is concern over the savings rate, the effectiveness with which we put our resources to use, and the amount of resources we have to invest.

These are of concern to us. We think that there may be some salient effects of the 1986 tax reforms in terms of total savings. Obviously, the recent appreciation of foreign currencies relative to the dollar is going to have an effect. And getting the deficit further down will have an effect.

A lot of policies that we engaged in and were trying to champion are going to have an effect on physical investment. But also some of these policies in the science area and education area are going to have an effect on the investment in human capital.

Senator DANFORTH. Right. I am talking about of course both human capital and hard capital.

One of the criticisms of the 1986 tax bill is that basically what it did was to cash in a whole variety of incentives for investment, both in plant and equipment, and in education and in research, in order to obtain the low tax rates so that people could consume more.

The National Association of Manufacturers estimated that in one quarter the capital formation was down $27 billion as a result of the 1986 tax bill. I do not know if that is true or not, but that is one estimate of the effect of the 1986 tax bill.

You have provided, according to this chart on page 6c-2, in this budget, for what would seem to be a fairly significant percentage increase in nondefense investment, from $81.4 billion to $93.7 billion. And yet, that would not begin to make up for the effects of the tax bill.

And my question is, in the last year of this administration, and looking down the road, I suppose not much is going to be done this year, but do you have any thoughts for what we should be thinking about with respect to tax laws, with respect to Federal spending, and the fact that some would say that we are greatly under-investing in the future of the country?

Mr. MILLER. Well, let me say—it is hard to take off my hat as a public official who happens to be Director of the Office of Management and Budget. But in looking at the longer term, I think we need to be very concerned about investment policy; not so much investment policy, but the scale of investment, and also the scale of savings in this country. And obviously, public policies affect this.

We have had the 1986 tax reform. I think we need to see—this is the first full effective year of the tax bill. I think we need to see how it settles out.

I would not be surprised if Congress in the next few years took a hard look at the structure of taxes. The President has already indicated his support for reducing the capital gains rate. That itself would have an effect on total savings and total investment.

These are issues of great importance. I mean, if you look at the predicates of economic growth, they typically relate to savings rates and investment rates, but also to changes in technology which are mostly responses to investments in education.

And I think those areas in the long term are areas that we ought to work on very diligently. And I mean investments in education. I do not necessarily mean money investments in education.

Probably now, in terms of what we could exercise, simply encouraging parents to be more appreciative of the importance of their children's schooling and doing homework and attitudes and aspirations and ambitions for them are very important factors.

Chairman CHILES. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

Dr. Miller, I want to accentuate this positive this morning.

Mr. **Miller**. Good. Thank you, sir.

Senator **Sasser**. And quite frankly, I think this is perhaps the best budget the administration has brought here to the Congress.

Some of my colleagues might say that I am damning it by faint praise in heaping that accolade on it. But I think this budget does indicate, I think for the first time, a willingness on the part of the administration to work with the Congress, to some extent.

And I want to try to foster that spirit, and hopefully, we can make it even grow as time goes on.

Now, one of the things that I take heart from are the defense figures. I think for the first time, under the direction of Secretary of Defense Carlucci, the administration is starting to make some hard choices over there in the Department of Defense.

I saw some figures not too long ago where a scholar in the field of defense expenditures indicated that using the techniques that were used at DOD under the tenure of Robert MacNamara as Secretary of Defense, what the present administration was buying for $330 billion in defense outlays could have been purchased, using MacNamara techniques, for somewhere in the neighborhood of $273 billion.

Now, if you multiply that savings out over 7 or 8 years, you have got a number close to half a trillion dollars.

So if we had been using—I think making the tough choices, and using more sophisticated techniques over in DOD, our deficit would not be as alarmingly high as it is now.

So there is a glimmer of hope, I think, in some of the judgments that Secretary Carlucci is making.

I applaud you for increasing expenditures in education. There is an 18 percent increase in Pell grants, in this budget. A 29-percent increase in basic science and energy programs.

So I think we are moving down a road in which there is room for compromise and cooperation with the Congress, and I think that is the first step toward trying to do something about the deficit, and doing something realistic.

Now, I think we all would agree on this committee, or at least most of us, that the economic projections of the administration are unduly rosy here today, and perhaps unduly optimistic.

I do not expect you to agree with that. But if we use the CBO projections, which I happen to think are more realistic, then we are going to end up with a deficit of $176 billion, which puts us roughly $40 or $50 billion over the Gramm-Rudman-Hollings target.

Would you anticipate, Mr. Miller, if we do find ourselves going over the Gramm-Rudman-Hollings target, would you anticipate another economic summit? And I am sure the chairman of the Budget Committee would look forward to another one of those 6 weeks or 8 weeks conferences.

But would you anticipate another economic summit?

Mr. **Miller**. Let me say, Senator, if it turned out next summer that it looked increasingly like the assumptions that we would have to make—and under Gramm-Rudman-Hollings law, as you know, it is the OMB's assumptions that would prevail—if it looked increasingly like the administration's assumptions, applied to the budget agreement, would not get us within the $146 billion budget deficit figure then I would say that the chances would be high that the Congress and the administration ought to get together and figure out a way of avoiding sequestering.

Senator SASSER. Let me just ask you this, Dr. Miller: Why the difference here between the economic projections between the administration, the Office of OMB, your rosier economic projections, and the economic projections of the Congressional Budget Office and the average of the Blue Chip predictors.

How do you arrive at these predictions?

Mr. MILLER. Well, let me just say how we arrive at our own projections. And that is that we look at trends and mathematical models and econometric models of the economy, and we apply a bit of back-of-the-envelope estimating, and we talk to a lot of people within the administration——

Senator SASSER. That's not the same envelope we calculated the Laffer curve on, is it?

Mr. MILLER. No, that was a napkin. And we put all this together and come up with our best judgment, the Secretary of the Treasury, the Chairman of the Council of Economic Advisers and the Director of OMB get together, and work out these numbers to the best—the most appropriate numbers.

We make judgments about what is going to happen in various markets, what will happen in the oil market, what will happen in the money market, et cetera.

Senator SASSER. But there is a substantial amount of subjective judgment in these numbers?

Mr. MILLER. There is inevitably a certain amount of subjective judgment in these numbers.

Senator SASSER. And we all hear accusations on occasion that the wish might be the father of the thought in some of these economic predictions.

Mr. MILLER. Well, but let us go to the record, Senator. As I indicated before, in a couple of years we overestimated growth, a couple of years we underestimated growth.

Last year I came and sat right here, again, as I said before, and people said, your predictions are far too optimistic. Your projections of the economy are far too optimistic.

Yet they were not optimistic enough. Because the economy performed better than we had anticipated.

We used very similar methodology this time in coming up with our numbers. I think the numbers are very defensible. We show that the GNP deflator for Fiscal Year 1988 is above the 1987 actual, and for 1989, we show it above the 1987 actual, although we think that the inflation rate will go down 0.2 of a percentage point from our 1988 figure, whereas CBO thinks it will go up 0.2 perentage point from their figure.

Senator SASSER. Let me interrupt, Dr. Miller. My time is running out, and I want to ask one additional, very quick question.

Now, your whole scenario here is built on what I perceive to be optimistic, perhaps overly optimistic economic projections.

Now, one way to make this wish come true on the part of OMB is to have a healthy, dynamic economy. Now, today, we still have relatively high interest rates—the Federal discount rate is at 6 percent. The prime rate stands at 8.75.

Real interest rates today are at 5 percent, which is a very, very high rate. Historically, real interest rates, I think you know as a learned economist, stand somewhere between 1½ to 2 percent.

So we have very, very high real interest rates. Now, one way to keep this economy going is to lower that discount rate.

Are you prepared, as Chairman of the Office of Management and Budget, to recommend to the President that he jawbone Alan Greenspan to bring those discount rates down?

Mr. MILLER. Well, our position is that the Fed is performing its duty now, and certainly, we do not have differences with the Fed to an extent that would prompt us to recommend to the President that he try to engage in any public or private jawboning of the Fed.

Chairman CHILES. Senator Quayle.

Senator QUAYLE. Thank you very much, Mr. Chairman. Welcome, Director Miller.

My first question, maybe has already been covered by the chairman or the ranking member, and if so, I apologize. Have we established that the compromise of last year reached between the executive branch and the congressional branch, with regard to the defense number, that this figure was a floor as well as a ceiling on the budget authority in outlays?

Is there any misunderstanding on that particular point? I do not know if this point has been brought up, but if it has not, I want to make sure that it is clearly understood what the compromise that was reached last December is on defense spending.

Mr. MILLER. That is surely my understanding. That is my belief that is the understanding of the vast majority of the members of the negotiating team.

It is stated forth in the package that was circulated as the budget agreement was concluded that it would be. And let me read. Number seven says: Agreed upon discretionary spending levels are as follows.

And it lists the domestic, international affairs and defense 050 account spending levels. The defense number was in fact one of the main issues that the negotiators on the part of the President wanted to nail down.

Senator QUAYLE. And in your mind, and in your opinion, of the vast majority of the negotiators, it was understood to be a floor as well as a ceiling.

Mr. MILLER. They were the numbers. And that is the reason the President's budget comes up to those precise numbers. The President's preferences would be to have a higher number for defense and a lower number for domestic discretionary spending and entitlement spending.

But we did not do that. We came in with the number we agreed to.

Senator QUAYLE. Well, the reason I bring it up is, because we go through this ritual of defense spending yearly. I have been one of those Senators who believes, when, all of a sudden we reach a low plateau, and we have a list of programs that Secretary Carlucci brought up yesterday that are going to be terminated, that many in Congress will try to put those programs back in.

There will be a lot of congressional add-ons as always in the defense budget. But once the Pentagon antes up, certain programs are going to be eliminated; but Congress starts to put them back. And then all of a sudden you get into a budget squeeze, and say, well, let's just take some more out of defense.

And you just get on this slippery slope and keep going down and down. Defense has been cut in real terms 11 percent over the last 4 years. Eleven percent decline in defense spending.

Chairman CHILES. Eleven percent off the wish list now?

Senator QUAYLE. Eleven percent in real terms.

Chairman CHILES. I wish you had been here a little earlier when we had a chart that showed defense, showed domestic programs, showed international spending and showed everything else. And the way I read the lines on that chart, I did not see any numbers going down.

In fact, you might just pull that chart out.

Senator QUAYLE. I can tell you this, and I do not think this number is wrong, now it has been used quite a bit in the Senate Armed Services Committee on a bipartisan basis, in fact, the chairman of the Senate Armed Services Committee said this yesterday in his opening remarks, that we have been on this decline in defense spending, in real terms, over the last 4 years, resulting in a real cut in defense spending of 11 percent.

Now that was in real terms in the last 4 years. I cannot read that big chart. But if you look in real terms—I do not have it, but I can produce one for you that shows you in real terms—where the defense budget has gone in real terms in the last 4 years. It has gone down.

Mr. MILLER. Mr. Chairman, what we have here is 1987 through 1993.

Chairman CHILES. But you had another chart up there that showed the levels earlier.

Mr. MILLER. Would you point out to me which chart it was? I would be glad to put it up.

Chairman CHILES. Page 9, I think.

Mr. MILLER. OK. Well, let me just mention, we have the national defense numbers. Outlays were $282 billion in 1987 and $285 billion for 1988. And that is a 1 percent increase. And as the Senator indicated, a real decline.

The same thing is true of budget authority, which went from $287 billion to $291 billion. That was page 9, sir?

Senator QUAYLE. Those are nominal figures. Maybe we can get the staff to produce a chart going back to fiscal year 1985, through this request, fiscal year 1989, and you will see, add it all up, in real terms, that you have a real cut in defense spending of 11 percent.

Now, if I am mistaken, I stand to be corrected. I do not think you will find in those terms, going back to fiscal year 1985 through fiscal year 1989 that I am mistaken however. And I want to make sure that everyone understands that. And I also want to make sure that everyone understands what the agreement is on defense spending.

Because I predict that we will get right back into this argument that we do every year, oh, we need some more for other programs; we will just take it out of defense. Well, we have taken it out of defense already.

And I can guarantee you, Congress will add these programs back that the Department of Defense has cut out.

One other question on a different subject than defense spending——

Chairman CHILES. I need to kind of hold you to your time, because there are some people who have been here from the very start and haven't had question yet——

Senator QUAYLE. OK, one quick question.

Chairman CHILES. Including the ranking member and the chairman.

Senator QUAYLE. I had one quick statement—but I was interrupted on my time.

Chairman CHILES. Yes; you are right.

Senator QUAYLE. I just wanted to congratulate you, Dr. Miller, on including the enhanced rescission authority. And I also want to encourage you to send up to Congress some rescission measures this year. And even though you do not have that additional authority, send them up and see what we can do with it. Package it in a good, strategic way that would be difficult for the Congress to say no, and let some of us try to go to work.

And I also encourage you to continue with those reforms. We are going to have to reform ourselves in this budget process at some time.

So I congratulate you on that, and I encourage you to send those measures.

Thank you for your indulgence, Mr. Chairman.

Chairman CHILES. Thank you. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

First of all, I just feel constrained to say on defense spending, my understanding on defense spending over the years of this President that we have had close to a 50 percent increase in real terms in budget authority for defense.

I think the suggestion that defense has been cut is just terribly misleading.

Senator QUAYLE. In real terms it has been cut.

Senator CONRAD. No; over the years of this President in real terms the defense budget has increased dramatically; nearly 50 percent.

The suggestion that it has been cut is just not accurate.

Mr. MILLER. Since 1985.

Senator CONRAD. Well, I am talking about the years of this President. You can choose to start after you have had big increases, take a trend line and talk about a cut. That is the kind of doubletalk that I think gets us in trouble. It misleads the country.

I want to go further. Frankly I think all of us here today are participating in what amounts to a charade and a hoax.

I heard on the radio coming to work yesterday that the President's budget is faithfully sticking to the summit agreement to reduce the deficit $76 billion over the next 2 years.

In 1987 the budget deficit was about $150 billion according to your projections it will be $130 billion in 1989. If we followed Gramm-Rudman-Hollings rules, your projected deficit would be $140 billion.

And of course, there are all kinds of arguments about how much smoke is in these numbers. Let us not get into that right now. Let us just deal with what we are telling the American public, what they are concluding from that, and what the reality is.

When I went home over this break, I went to a series of town meetings. I said how many here have heard that we are reducing the deficit $76 billion over the next 2 years under the summit agreement between the President and the legislative leadership?

Well, everybody had heard that number.

And I said, how many of you believe it? Well, very few believed it. And I assured them that they were correct. Because when people talk about reducing a deficit, the average person concludes we reduced it from what it used to be. Of course we are not.

As these numbers make abundantly clear, the deficit is not going down $76 billion over the next 2 years. Even by the most optimistic predictions, it is going down some $20 billion. If we are following Gramm-Rudman-Hollings rules, the reduction is only $10 billion.

If we are looking at more objective economics that some like the blue chip indicators and CBO have come forward with, the deficit is going up.

The reaction of people in my home, when I tell them that the $76 billion is not off what the deficit used to be, but off a projection of what the deficit might be 2 years from now, they are just utterly disgusted with all of us.

I hope that somehow we adopt language that is more honest and communicates more accurately what we are doing.

The truth is, we are not reducing the deficit at all or, even by these optimistic numbers, very marginally. The legacy of this administration is going to be a tripling of the national debt, sixfold increase in the trade deficit, and a mighty deep hole that we are going to have to dig out of in the years ahead.

The sad, sad reality is, we are not starting the process of digging out at all.

My question goes to another matter: Federal credit reform. I am told that under Federal credit reform, you are requiring agencies to pay an add-on subsidy to point out the difference between the cost of a loan from a private source and the cost from the Federal Government.

The effect, I am told, is to make it appear as though there is an increase in the budget. For example, guaranteed student loans in education. In the past, the budget contained only the loan amount. Now the budget is requiring the loan amount and the subsidy amount to make it appear as though there is a big increase, while there is really no increase in loans available to students.

Is that an accurate assessment, or has somebody misunderstood?

Mr. MILLER. Somebody misunderstood. Senator Conrad, I hope given your background that you would look very closely at that.

What we proposed this year, what we proposed last year, is that this whole business of government loans be put on a basis where people can understand it, so you decisionmakers will understand what in fact is at stake.

The system we have is a rather strange one. What we do when the government gives a direct loan of, say, $10 million, you count that as a $10 million outlay, even though some of it is going to be repaid in an expected value sense.

Then when the loan is repaid, you count that as an negative outlay, an offsetting receipt.

Senator CONRAD. So in other words, what you are attempting to do here is to make clear what really is happening.

Mr. MILLER. That is exactly right.

Senator CONRAD. That I applaud. Why do we not do the same thing when we tell the American people what we are doing about the deficit?

Mr. MILLER. Well, I think the package of materials and discussions by the leadership of Congress went to the point that this package of savings was off of a Gramm-Rudman-Hollings baseline based on 1987.

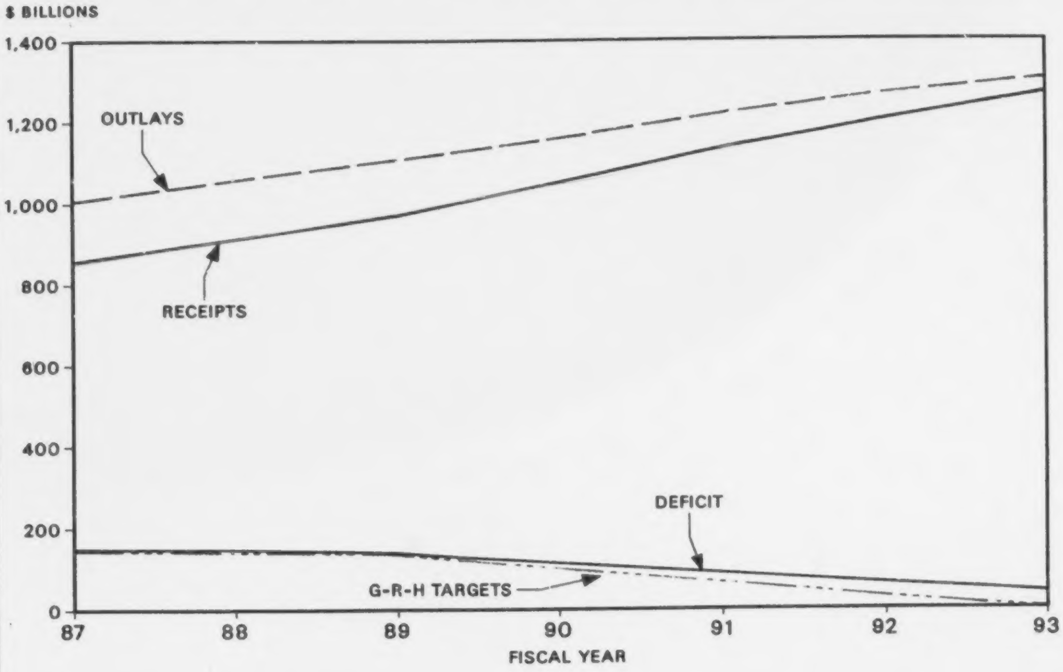
Senator CONRAD. What do you think the reaction of people out there is going to be when they find out we have not reduced the deficit at all?

There is all this talk about $76 billion, and the truth is, the deficit is not going down.

Mr. MILLER. Put up page 5 please.

Senator, I would direct your attention to page 5 of the package of material, the highlights there. And as you can see from that, the deficit goes from about $150 billion in 1987, down to $23 billion in 1993. The President's budget meets the Gramm-Rudman-Hollings target in 1989 and falls short of it by $4 billion in 1990.

OUTLAYS, RECEIPTS, DEFICITS, AND G-R-H TARGETS



Now, the reasons we did not rotate that line all the way down to zero in 1993 is because there would be some in Congress—I think erroneously—who would argue that to have done that—to have made changes in policy in 1990 and out into the outyears—to rotate the line down would have been inconsistent with the budget agreement.

The President asked us forthrightly, directed us forthrightly, to come up with a budget that met the four corners of the agreement, even in appearances.

So I would disagree with you. This budget deficit will come down.

Senator CONRAD. Well, let me just sum up by saying, what we told the American people is that we are reducing the deficit $76 billion over the next 2 years.

Even by your numbers, which many say are very optimistic, we are not doing that. We are nowhere close to doing that. And by most numbers, the deficit is going up, not down.

Gramm-Rudman-Hollings estimates by CBO show that by the end of 1993, we will be at $125 billion; not zero, $125 billion.

What is troubling to me is what I think is very misleading language to the American public.

My time has expired.

Chairman CHILES. Senator Domenici.

Senator DOMENICI. Mr. Chairman, I will be very brief.

I want to congratulate you, Mr. Miller, and the President. You included in this budget, under very constrained times, once we knew what the domestic expenditures could be, increase in scientific research applied to health and those related areas, and scientific research in space.

Clearly, when this U.S. Senate went to the floor with a trade bill, you were not there, you were over in your office, but for days we spoke of investing in science and research, improving the quality of knowledge in our universities in fields of science and physics. Everyone stood around and took their shot at making sure that that trade bill had something in there to increase our competitiveness.

The theme of it all was, applied science. The trade bill had technology trade centers. We had centers of excellence that we all dreamt up and passed.

The truth of the matter is that this budget is recommending that we take proven programs in those areas and increase them, from NIH to NSF to NASA and others.

So if we want to increase these areas, we have got to find savings some place else in the domestic appropriated arena. We cannot take funds from defense or foreign aid. Is that how you understand the agreement?

Mr. MILLER. Yes; that is my understanding also, Senator.

Senator DOMENICI. And you have taken these increases, and had to eliminate or reduce other programs within domestic discretionary. Congress will have to decide when they get to the appropriation process what they want to do; is that right?

Mr. MILLER. That is correct.

Senator DOMENICI. Mr. Miller, with reference to trust funds, would you do the committee a favor if the chairman agrees, and would you provide, either on your own or through the Social Security Administration, a flow chart showing the accumulation of trust funds in social security and medicare over the next 35 years? Please show how it goes up and how it comes down.

Mr. **Miller**. I will do that.

Senator **Domenici**. Please tell us as best they are able to predict it, based on the same vagaries of economic assumptions that we are regularly subject to.

But I would like to know when it starts dipping, because I think it is important when we look out into the future that we not count on that fund being available as a source of capital to the Treasury indefinitely.

For now it is, because it is taxpayers' money that is accumulated there. We use it as a draw against other capital we have to borrow. But at some point that will change.

And I would like to see the flow on that, if you would, please.

[The following was subsequently supplied for the record by the Office of Management and Budget:]

OLD AGE, SURVIVORS, AND DISABILITY INSURANCE TRUST FUNDS
Income, Outgo, and Balances Under Alternative IIB Assumptions
Based on the 1987 Social Security Trustees Report
(nominal dollars in millions)

Calendar Year	Balance at Beginning of Year	Income	Outgo	Balance at End of Year	Difference Between Beginning and Ending Balances
1988	67,016	259,443	222,607	103,852	36,836
1989	103,852	279,467	238,095	145,224	41,372
1990	145,224	309,448	255,054	199,618	54,394
1991	199,618	334,169	273,241	260,546	60,928
1992	260,546	360,720	291,067	330,199	69,653
1993	330,199	387,638	309,466	408,371	78,172
1994	408,371	415,745	328,901	495,215	86,844
1995	495,215	445,393	349,406	591,202	95,987
1996	591,202	477,254	371,109	697,347	106,145
1997	697,347	511,020	391,045	817,322	119,975
1998	817,322	547,411	409,576	955,157	137,835
1999	955,157	586,235	429,324	1,112,068	156,911
2000	1,112,068	627,442	450,253	1,289,257	177,189
2001	1,289,257	671,129	472,641	1,487,745	198,488
2002	1,487,745	720,427	496,818	1,711,354	223,609
2003	1,711,354	773,022	522,933	1,961,443	250,089
2004	1,961,443	829,531	551,770	2,239,204	277,761
2005	2,239,204	889,710	583,496	2,545,418	306,214
2006	2,545,418	954,243	614,428	2,885,233	339,815
2007	2,885,233	1,021,776	656,298	3,250,711	365,478
2008	3,250,711	1,092,952	702,859	3,640,804	390,093
2009	3,640,804	1,168,655	755,310	4,054,149	413,345
2010	4,054,149	1,247,735	813,264	4,488,620	434,471
2011	4,488,620	1,330,956	876,585	4,942,991	454,371
2012	4,942,991	1,417,349	945,835	5,414,505	471,514
2013	5,414,505	1,509,846	1,021,227	5,903,124	488,619
2014	5,903,124	1,604,183	1,104,221	6,403,086	499,962
2015	6,403,086	1,701,934	1,195,574	6,909,446	506,360
2016	6,909,446	1,803,869	1,294,775	7,418,540	509,094
2017	7,418,540	1,908,499	1,401,856	7,925,183	506,643
2018	7,925,183	2,017,894	1,516,622	8,426,455	501,272
2019	8,426,455	2,129,836	1,639,716	8,916,575	490,120
2020	8,916,575	2,246,598	1,770,846	9,392,327	475,752
2021	9,392,327	2,366,881	1,909,931	9,849,277	456,950
2022	9,849,277	2,490,562	2,056,932	10,282,907	433,630
2023	10,282,907	2,617,757	2,212,752	10,687,912	405,005
2024	10,687,912	2,749,100	2,377,545	11,059,467	371,555
2025	11,059,467	2,884,805	2,550,677	11,393,595	334,128
2026	11,393,595	3,025,013	2,731,762	11,686,846	293,251
2027	11,686,846	3,168,518	2,920,025	11,935,339	248,493
2028	11,935,339	3,319,682	3,115,383	12,139,638	204,299
2029	12,139,638	3,476,398	3,317,275	12,298,761	159,123

Calendar Year	Balance at Beginning of Year	Income	Outgo	Balance at End of Year	Difference Between Beginning and Ending Balances
2030	12,298,761	3,638,757	3,526,450	12,411,068	112,307
2031	12,411,068	3,807,362	3,743,480	12,474,950	63,882
2032	12,474,950	3,982,891	3,970,177	12,487,664	12,714
2033	12,487,664	4,165,212	4,204,952	12,447,924	(39,740)
2034	12,447,924	4,353,385	4,445,006	12,356,303	(91,621)
2035	12,356,303	4,548,428	4,691,484	12,213,247	(143,056)
2036	12,213,247	4,751,425	4,946,235	12,018,437	(194,810)
2037	12,018,437	4,963,061	5,211,606	11,769,892	(248,545)
2038	11,769,892	5,184,983	5,488,694	11,466,181	(303,711)
2039	11,466,181	5,417,314	5,779,120	11,104,375	(361,806)
2040	11,104,375	5,658,836	6,085,421	10,677,790	(426,585)
2041	10,677,790	5,909,591	6,407,895	10,179,486	(498,304)
2042	10,179,486	6,175,031	6,747,457	9,607,060	(572,426)
2043	9,607,060	6,448,781	7,108,412	8,947,429	(659,631)
2044	8,947,429	6,733,802	7,492,371	8,188,860	(758,569)
2045	8,188,860	7,030,102	7,898,558	7,320,404	(868,456)
2046	7,320,404	7,337,312	8,330,934	6,326,782	(993,622)
2047	6,326,782	7,656,820	8,790,606	5,192,996	(1,133,786)
2048	5,192,996	7,989,817	9,280,389	3,902,424	(1,290,572)
2049	3,902,424	8,336,108	9,801,509	2,437,023	(1,465,401)
2050	2,437,023	8,694,881	10,354,226	777,678	(1,659,345)
2051	777,678	9,064,827	10,939,057	(1,096,552)	(1,874,230)
2052	(1,096,552)	9,452,563	11,558,091	(3,202,080)	(2,105,528)
2053	(3,202,080)	9,855,003	12,212,016	(5,559,093)	(2,357,013)
2054	(5,559,093)	10,273,138	12,901,207	(8,187,162)	(2,628,069)
2055	(8,187,162)	10,702,313	13,628,424	(11,113,273)	(2,926,111)
2056	(11,113,273)	11,151,816	14,395,653	(14,357,110)	(3,243,837)
2057	(14,357,110)	11,618,294	15,201,697	(17,940,513)	(3,583,403)
2058	(17,940,513)	12,101,460	16,051,178	(21,890,231)	(3,949,718)
2059	(21,890,231)	12,601,951	16,947,557	(26,235,837)	(4,345,606)
2060	(26,235,837)	13,119,881	17,888,872	(31,004,828)	(4,768,991)

TABLE II.—ESTIMATED OPERATION OF THE HOSPITAL INSURANCE TRUST FUND DURING CALENDAR YEARS 1986–2010, UNDER ALTERNATIVE SETS OF ASSUMPTIONS

[Dollar amounts in billions]

Calendar year	Total income	Total disbursements	Interfund borrowing transfers [1]	Net increase in fund	Fund at end of year	Ratio of assets [2] to disbursements (percent)
		ALTERNATIVE I				
1986 [3]	$59.3	$50.4	$10.6	$19.5	$40.0	41
1987	63.9	49.1		14.8	54.8	81
1988	68.5	55.9		12.6	67.4	98
1989	73.7	60.8		12.9	80.3	111
1990	79.0	66.1		12.9	93.2	121
1991	84.1	71.1		13.0	106.2	131
1992	89.0	75.7		13.3	119.5	140
1993	93.7	80.2		13.5	133.0	149
1994	98.4	84.7		13.7	146.7	157
1995	103.3	89.3		14.0	160.7	164
2000	135.7	116.0		19.8	246.3	195
2005	179.0	148.2		30.8	375.7	233
2010	233.6	187.5		46.1	573.4	281
		ALTERNATIVE II–A				
1986 [3]	59.3	50.4	10.6	19.5	40.0	41
1987	63.7	49.1		14.6	54.5	81
1988	68.0	56.0		12.1	66.6	97
1989	73.0	61.5		11.5	78.1	108
1990	78.2	67.8		10.4	88.5	115
1991	83.3	74.1		9.2	97.8	120
1992	88.4	80.5		7.8	105.6	121
1993	93.2	87.2		6.1	111.7	121
1994	98.2	94.2		4.0	115.7	119
1995	103.2	101.6		1.6	117.3	114
1996	108.5	109.1		−0.6	116.7	107
1997	114.1	116.9		−2.8	113.8	100
1998	120.0	125.3		−5.3	108.5	91
1999	126.2	134.3		−8.1	100.4	81
2000	132.6	144.0		−11.4	89.0	70
2001	139.1	154.1		−15.0	73.9	58
2002	145.7	164.9		−19.2	54.8	45
2003	152.5	176.5		−24.0	30.8	31
2004	159.5	188.8		−29.3	1.5	16
2005	166.7	201.9		−35.3	([4])	1
		ALTERNATIVE II–B				
1986 [3]	59.3	50.4	10.6	19.5	40.0	41
1987	63.3	49.1		14.2	54.1	81
1988	67.4	56.0		11.4	65.5	97
1989	72.0	61.6		10.4	75.9	106
1990	77.3	68.4		8.9	84.8	111
1991	82.7	75.4		7.4	92.1	112
1992	88.3	82.6		5.7	97.8	112
1993	93.7	90.1		3.7	101.5	109
1994	99.3	98.0		1.2	102.7	103
1995	104.9	106.5		−1.6	101.1	96
1996	110.7	115.2		−4.5	96.6	88
1997	116.7	124.3		−7.7	88.9	78
1998	122.8	134.2		−11.4	77.5	66
1999	129.2	144.9		−15.7	61.8	53
2000	135.8	156.4		−20.6	41.2	40
2001	142.5	168.5		−26.1	15.2	24
2002	149.3	181.4		−32.1	([5])	8
		ALTERNATIVE III				
1986 [3]	59.3	50.4	10.6	19.5	40.0	41

TABLE II.—ESTIMATED OPERATION OF THE HOSPITAL INSURANCE TRUST FUND DURING CALENDAR YEARS 1986–2010, UNDER ALTERNATIVE SETS OF ASSUMPTIONS—Continued

[Dollar amounts in billions]

Calendar year	Total income	Total disbursements	Interfund borrowing transfers [1]	Net increase in fund	Fund at end of year	Ratio of assets [2] to disbursements (percent)
1987	62.0	49.1		12.9	52.8	81
1988	64.5	56.1		8.4	61.2	94
1989	68.9	62.6		6.4	67.6	98
1990	72.3	69.8		2.6	70.2	97
1991	77.4	78.4		−1.0	69.1	90
1992	82.4	88.0		−5.6	63.6	79
1993	87.5	98.5		−11.1	52.5	65
1994	92.4	110.1		−17.7	34.9	48
1995	97.2	122.73		−25.5	9.4	28
1996	101.9	136.1		−34.2	(6)	7

[1] A loan of $12.4 billion to the OASI trust was made in 1982. This loan was still an asset of the HI trust fund; however, since these assets were not immediately available for payment of HI benefits, they were subtracted from the HI fund balance. The positive amounts shown represent repayments of principal to the HI trust fund.

[2] Ratio of assets in trust fund at the beginning of the year to disbursements during the year.

[3] Figures for 1986 represent actual experience.

[4] Trust fund depleted in calendar year 2005.

[5] Trust fund depleted in calendar year 2002.

[6] Trust fund depleted in calendar year 1996.

Note: Totals do not necessarily equal the sum of rounded components.

Senator Domenici. My last question is in reference to defense. Is it correct that while you have eliminated weapon systems, reduced manpower, both civilian and military in all of the services, that you nonetheless recommend a pay increase of 4.3 percent in FY 1989 for the military?

Mr. Miller. That is correct.

Senator Domenici. And that will not be decided by us, as I understand it, by the committees, but by the committees of jurisdiction authorizing or appropriating.

Just quickly, would you tell us why, since that costs a little bit of money, you did that in lieu of further weapons system reductions or personnel reduction?

Mr. Miller. It costs about a billion dollars. It is, as you indicate, absorbed into the Defense Department top line that we have agreed to.

The reason is the perception that to maintain the quality and integrity of the volunteer Army at the margin is more important than an extra billion dollars in hardware or other Department of Defense inputs.

Senator Domenici. Now, Mr. Chairman, I would like to ask the Director if he is aware of how the blue chip forecast compare to OMB and CBO.

I understand that blue chip comes out with a forecast update in February.

Mr. Miller. They come out with one every month.

Senator Domenici. All right. Has their February forecast compared to their January one, as a general proposition, become more optimistic?

Mr. Miller. As I recollect, there was very little change, one-tenth of a percent.

Senator **Domenici**. So my staff tells me that in the February survey, 31 of the 54 surveyed raised their forecasts from January. I assume you are looking?

Mr. **Miller**. I would accept that, subject to check.

Senator **Domenici**. Mr. Chairman, I want to put in the record, a chart with reference to defense and defense expenditures, because I think we are talking about defense in terms of its growth or non-growth.

I would like to put a chart in which, for consistency, uses real growth. And we have done that regularly around here. You know, when we talk about reducing a domestic program, we start with a concept of real growth equal to the rate of inflation.

I have numbers for budget authority using that same concept, which if we use for domestic, we ought to use for defense. And it is rather startling: 219, 238, 248, 267, 252, 245, 242, 239. Which means budget authority in real terms is coming down for the fourth consecutive year.

If I apply a percent to that, the percent growth over the entire span in real terms is 11 percent.

Now one can use whatever baseline they want. But if you are going to, for domestic and other programs, use inflation added to the base as a starting point, and then say when you have cut that you have cut the program, I think you ought to apply the same theme, at least, to defense.

And I think those are the numbers I'd ask be——

Chairman **Chiles**. The chart will be added in the record.

Senator **Domenici**. I thank the chairman.

Chairman **Chiles**. And I would like to put one in, as well, that shows the actual constant dollars in regard to defense.

[The charts referred to follow:]

DEFENSE SPENDING AUTHORITY IN REAGAN ERA

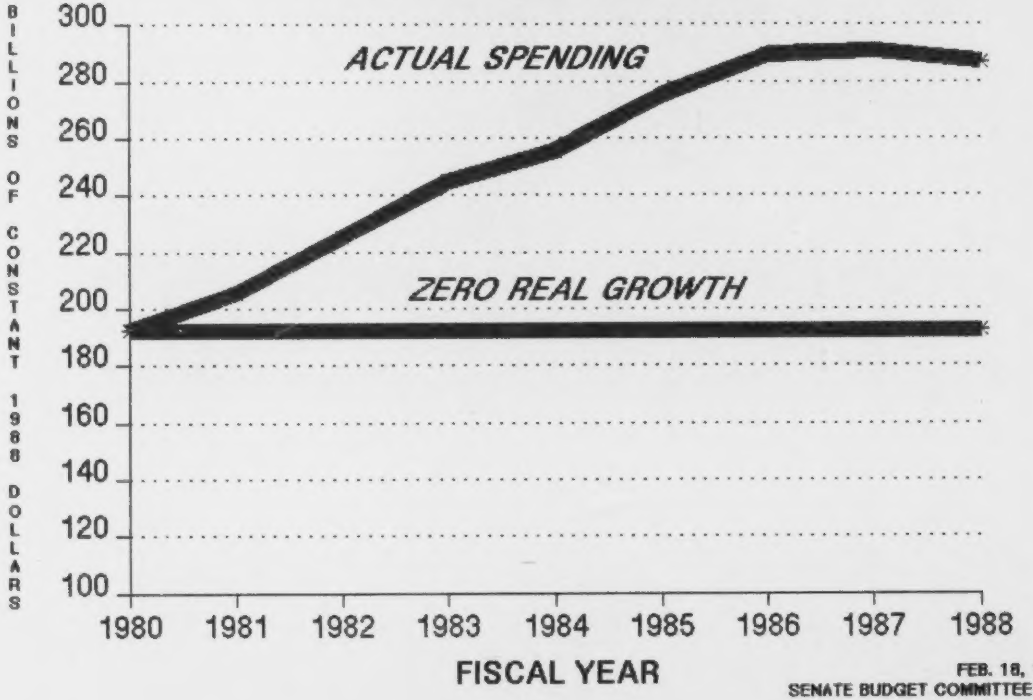
[Dollar amounts in billions]

	Fiscal year—							
							Summit agreement	
	1982	1983	1984	1985	1986	1987	1988	1989
Nominal dollars	$216.5	$245.0	$265.2	$294.7	$289.1	$287.4	$291.5	$299.5
Real dollars	$219.2	$238.0	$248.2	$267.1	$252.7	$245.2	$242.3	$239.2
Real growth (percent)	12.0	8.6	4.3	7.6	−5.4	−3.0	−1.2	−1,3

Note: Calculations for real growth for fiscal year 1980–86 based on actual deflators. Fiscal year 1987–89 calculations based on CBO economic assumptions as of February 1988.

Source: Prepared by SBC Republican staff, Feb. 2, 1988.

DEFENSE OUTLAY GROWTH IN THE 1980S
THE REAGAN LEGACY



FEB. 18, 1988
SENATE BUDGET COMMITTEE STAFF

Senator **Domenici**. Thank you very much for the time.

Chairman **Chiles**. Senator Wirth.

Senator **Wirth**. Thank you very much, Mr. Chairman. Mr. Miller, delighted to have you here today, and know that you are still alive in the process of having to put together a budget.

Mr. **Miller**. Just barely.

Senator **Wirth**. It is close to the most thankless job in town.

Mr. Chairman, I just wanted to associate myself with the comments of both the previous Senators, Senator Domenici's comments on investments in science and our future, and the importance of doing that; and also, unfortunately, Senator Conrad's very good comments on the credibility of the budget.

I must say, Senator Conrad, I was sorry to see Bruce Babbitt drop out of the race yesterday. Because I thought of all the people running, he was one of the few, if not the only one, who was being honest about the enormous charade that we are faced with.

And I find myself stunned by the fact that in this campaign we have seen remarkably little addressing the reality of a budget that when you look at either blue lines or black lines or red lines, the reality of the situation is, it is getting worse and worse.

And if you take all of the Social Security off the budget, and the trust funds off the budget, the on-budget deficit is getting bigger and bigger; it is not a good situation at all.

I hope that maybe after we get through this year, and this presidential campaign, there will be the emergence of the kind of leadership to help coalesce the kind of concerns that I think exist not only in the Congress but all across the country.

I am struck as you are in town meetings that people are just appalled, angry, sick to death of it.

Mr. Miller, what was the statutory debt limit when you came to town in 1981?

Mr. **Miller**. I do not know what the statutory debt limit was at that time. I can tell you what the debt held in public hands was. As of 1980, it was a little less than $1.914 trillion.

Senator **Wirth**. And how much is it at the end of the President's 5-year plan?

Mr. **Miller**. At the end of 1993?

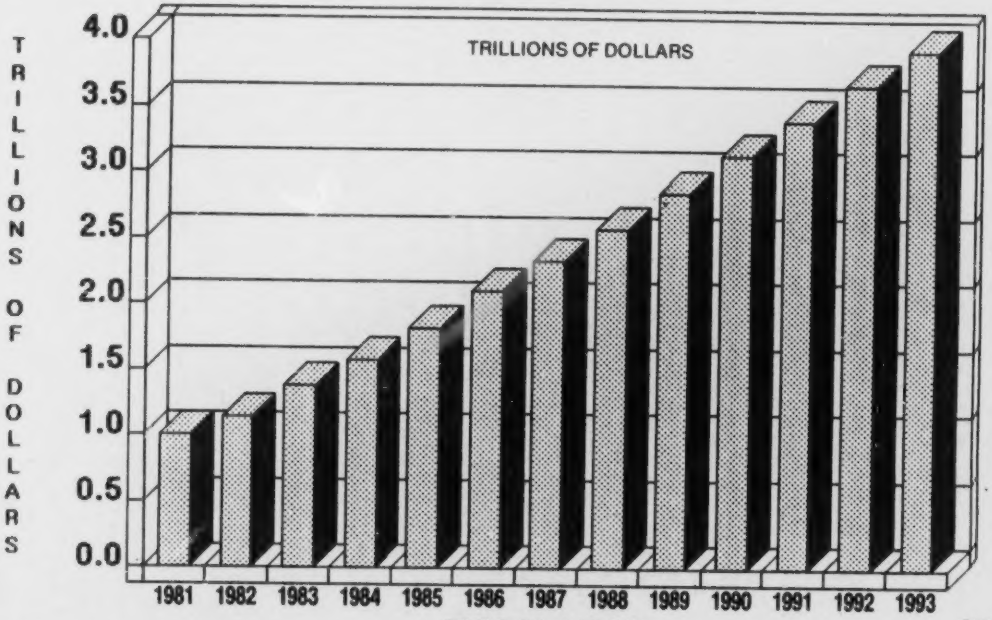
Senator **Wirth**. Yes.

Mr. **Miller**. We estimate it to be $3.654 trillion.

Senator **Wirth**. So why isn't it fair to say that part of the Reagan legacy is increasing the debt from $1 trillion to $3.6 trillion?

QUADRUPLING OF THE FEDERAL DEBT

1981 – 1993



Data: OMB and CBO

SBC staff
Feb. 4, 1988

Mr. MILLER. Well, the facts speak for themselves, but the facts also show that the Reagan legacy is one that, if you will look on pages 3 and 4 of the package, brought inflation rates down from 13.5 to——

Senator WIRTH. But I am just talking about the debt. I mean, I go to town meetings and people are worried about the debt. It just seems to me that there is plenty of blame to go around, and we always hear an enormous amount about the big-spending Congress.

I just think it is important to point out, for the record, that the numbers have gone, as you point out, from $1 trillion to $3.6 trillion, and, that has got to be part of the Reagan legacy. Again, there is plenty of blame to go around, but the reality of the situation is that that exists, and that goes to, I think, Senator Conrad's question.

Mr. MILLER. The President cannot spend a penny, though, that Congress does not appropriate.

Senator WIRTH. And we are in a situation, as you know, of figuring out how do we get out of this terrible mess.

In the New York Times the other day, you were quoted as saying, "The deficit will continue coming down. The debate will be over how to do it."

We hope that the first part of that statement is the case. I agree that the debate is over how to go about doing it.

You went on to say: "Republicans will have a 20-percent revenue increase and an 80-percent reduction in services. The Democrats will be 50–50."

Is that an accurate quote? Is that quote accurate?

Mr. MILLER. Yes; that quote is accurate. I was just making the——

Senator WIRTH. Does that mean that you and Ronald Reagan, or Ronald Reagan and you are agreed that there has to be some increase in revenue?

Mr. MILLER. No; I did not, I did not—that is not what I said.

Senator WIRTH. No; I am asking you if your saying that there has to be an increase in revenue means that the President is also now saying there has to be some increase in revenue?

Mr. MILLER. No; I did not say there has to be. I was asked, or I volunteered a statement about what I thought the future held, and that is what I believe. I think the difference between decisions that will be made under a Democratic President and under a Republican President is that the Democratic President will do some cutting from current services. He will also have a greater portion of the deficit reduction come out of revenues than would a Republican President.

Senator WIRTH. And you do not want to cut social security in any way, shape, or form, will not cut any retirement programs, will not cut any defense programs, and they are somehow going to find in the rest enough to balance the budget? There is not enough money there. You know that as well as I do.

Mr. MILLER. Senator, we have put the chart back up, and I will go over, again, what I think to be the likely outcome, certainly consistent with our assumptions, and with the——

Senator WIRTH. I have seen that. I have seen the chart. I have been through this a lot of times. I was on the House Budget Committee, and now on the Senate Budget Committee. I have heard discussions. We have just got to stop looking at charts, and look at reality—and the reality is there is not enough money there to do it.

You could make up all the charts in the world. The reality is there is not enough money to do it. It is not there. It just is not there.

Mr. MILLER. The reality is that I came up last year and said that our projections for the 1987 deficit were $173 billion, including $2 billion in outlay or rescissions, and $175 billion, without rescissions, and the deficit turned out to be $150 billion.

Now that was down from $221 billion obtained in 1986. So we had a $70 billion reduction in the deficit. Part of that was because we had the tax reform which generated some revenues in excess of current services.

Part of the problem this year is that tax reform has the other swing effect. But we have gotten the deficit down. If we continue to hang tough with the spending levels we will be able to get the deficit down to zero by 1993. I think it is eminently doable. We have made remarkable progress since the passage of Gramm-Rudman-Hollings, since the time when the Congress and the President said let's have——

Senator WIRTH. Excuse me. We have all heard the campaign speech, I know what you are saying, we have all been through it. And you know, I voted for Gramm-Rudman-Hollings.

The reality of the situation is we have gone from a $1 trillion to a $3.6 trillion deficit. How are we going to get out of it?

You all say there is no way in the world we are going to get out of it by making any changes in defense, or any changes in other programs. It just is not going to be done. We will muddle through this year, I am sure.

Let me ask you about a specific item related to education. As I noted my agreement with Senator Domenici about the need for investing in the future, last year in front of this committee, you and Secretary Bennett came up and defended your request for cutting $850 million out of education, perhaps more than that.

Last year you came up and requested a $5.7 billion cut. A $5.7 billion cut last year.

Mr. MILLER. I think that is a larger number than we had.

Senator WIRTH. What was the cut you were recommending in education last year?

Mr. MILLER. I do not have that information.

Senator WIRTH. But it was a big cut, though, wasn't it?

Mr. MILLER. It was a fairly good size.

Senator WIRTH. OK. And let me just ask you about what is going on, and just go into Senator Domenici's question. If you requested a big cut in education last year, and this year, an election year, you all are coming up and requesting an increase of $850 million, tell me what happened in the last year that would suggest that you go from wanting to cut education last year, to wanting to increase education this year, other than an election year?

Mr. MILLER. Well, I reject, Senator, the implication of your remark. I can tell you that——

Senator WIRTH. Well, I have been in politics a long time. You guys play politics with the budget. We understand that. Democrats of course will play politics with the budget, too.

Mr. MILLER. But you are making an allegation for which you do hot have, I think, any evidence.

Senator WIRTH. I am just looking at the numbers. I am asking you, what is the difference between last year and this year other than this is an election year and last year was not. Last year you were cutting education very significantly. This year you are adding to education.

What is the difference between last year and this year?

Mr. MILLER. I disagree, I disagree with——

Senator WIRTH. That is a valid question. What is the difference?

Mr. MILLER. I disagree with the premise of the statement.

Senator WIRTH. Well, would you disagree that this is an election year?

Mr. MILLER. No, I would not disagree.

Senator WIRTH. OK. It is an election year. All right. [Laughter.]

You agree that there was a cut last year, you agree that there is an increase this year, and you agree that this year is an election year. Now what is the difference between last year and this year that would make you increase education this year, having requested a cut last year? What is going on?

Mr. MILLER. You were stipulating, then, that you do not imply that the increase is because this year is an election year.

Senator WIRTH. Would I suggest that OMB ever played politics, Mr. Miller? Never. Would not think of.

Mr. MILLER. Having stipulated that, let me tell you: we came forward last year with a very simple notion, and that is that the imperfection in the capital market is what gives rise to the need for Federal intervention into higher education, and the proposal was to convert many Pell loans into guaranteed loans and that these guaranteed loan programs would actually accommodate more students. We lost that debate. We got creamed, because a lot of people came out and said you are cutting education, not understanding, not being willing to understand the difference between what we were proposing and what was conveyed by most of the people who were critics of what we had to do.

Having lost that debate, consistent with the notion of increasing——

Chairman CHILES. If that was the theory for cutting Pell loans, what was the theory for cutting drug education? There was not any capital market out there to take the place of——

Mr. MILLER. In drug education, Senator——

Senator WIRTH. It might have been all mergers and takeovers. Somebody has taken something, do you think? Sorry, Mr. Chairman.

Chairman CHILES. No, I want to know what the theory was last year. You added money back this year, and we are delighted. You have come up to the——

Mr. MILLER. Well, Mr. Chairman, as you know, there was the passage of the 1987 drug bill, which bestowed an enormous one-shot spending in the area of drug education, drug infrastructure, et cetera. Congress appropriated much less money for drugs, for the whole drug program last year than it did the year before.

We come and we propose a substantial increase in the amount of funding for the drug program this year.

Chairman CHILES. Your budget last year proposed cutting enforcement, treatment, and education for drugs, and Congress put back that money. And so what I am asking you is: what was the theory?

I wanted to know what the theory was, last year, for cutting the drug education money, cutting the enforcement money, cutting the drug treatment money.

Mr. MILLER. Well, I would like to go back and respond to you on the specifics of it, but basically, again, in 1987, Congress, responding to the President's initiative, passed a very substantial increase in drug——

Chairman CHILES. Responding to the President's initiative?

Mr. MILLER. I will give you a copy of the message of the President to the Congress.

Chairman CHILES. I think we responded a little bit more than the President expected.

Mr. MILLER. Yes. You surely did, and there were some areas of increases which the President did not ask for. But again, I would take issue with the notion that spending the money necessarily improves, or deals with the problem.

But in any event, as you know, in the 1987 drug bill, there was a substantial infusion of funds, much of it one-time funds, even the education area——

Chairman CHILES. No, sir. No, sir. There was nothing "one-time" about the education funds. We were starting, for the first time, a drug education program. We were starting a drug treatment program. I disagree that those were one-time funds.

Mr. MILLER. Well, Mr. Chairman, I will be glad to get back to you with details from the President's budget——

Chairman CHILES. I would be happy to hear that, and about your theories. You know, that is what got me off on this. I was not on this track until you started talking theories. I would like to know what the theory of cutting vocational ed was last year, bilingual ed, impact aid, handicapped, rehabilitation. Thank goodness, they are not being cut this year.

Mr. MILLER. Well, I will be glad to do that. I think, though, that you ought to focus this year right on what the President's proposal is.

Chairman CHILES. Fine. All right. I think that is right. All right. Let me get off that line of questioning, and let me ask you this. You have talked about the four corners of the agreement, and you have reminded us a deal is a deal, and we have got to keep the deal.

The summit agreement called for $14 billion in revenues in 1989. Page 4-20 of your budget explicitly notes that the $14.3 billion in new revenue is enacted in 1989. You have told us that again this morning in your testimony, that that is already gone. Yet your budget proposes about $2 billion in additional revenues in 1989, which are above and beyond the summit agreement.

Now that $2 billion is in there, is it not?

Mr. **Miller**. Subject to check. There are some very slight changes——

Chairman **Chiles**. That is a gross figure now.

Mr. **Miller**. That is a gross figure, and that figure is about——

Chairman **Chiles**. Well, tax on State and local employees, on their health benefits, that is in there, is it not?

Mr. **Miller**. Yes.

Chairman **Chiles**. That is new, is it not? That is a new tax?

Mr. **Miller**. Yes. That is new.

Chairman **Chiles**. Well, now that we have decided what our profession is—what is wrong with having $6 or $8 billion in new revenue, and reducing the deficit some—now we understand we are not chaste. We are only arguing about the price now, are we not?

Mr. **Miller**. No, no, sir. No, Mr. Chairman. I would not engage that profession. I would say, point out to you, that subject to my check——

Chairman **Chiles**. You do not think that you have engaged in just a wee little bit, about $2 billion worth?

Mr. **Miller**. The receipts net out. That is, there are a couple of proposals the President has, the R&D tax credit, for example, the loss from revenue there is made up by revenue elsewhere.

Chairman **Chiles**. Well, you are the one, Dr. Miller, who insisted that the $14.3 billion was a specific line, and that we could not tamper with it.

Mr. **Miller**. That is the number.

Chairman **Chiles**. You said that line was a gross figure, and I remember those summit agreements. We agreed it had to be "gross." We wanted to argue net all the time, and we were told, hell, no, we could not argue about net. We are talking about gross new taxes.

Mr. **Miller**. Mr. Chairman, would you look at the line described as "Proposed Legislative and Administrative Action." I think that nets out all the figures, and you see there is just very——

Chairman **Chiles**. Well, what I am looking at is the summit agreement, the $9 billion in receipts in 1989, and the $14 billion in receipts in 1988. The $9 billion in 1988 and the $14 billion in 1989 are gross figures?

Mr. **Miller**. Yes.

Chairman **Chiles**. And the ingredients composing these figures will be determined through the regular legislative process and conference agreements, subject to the President's signature or veto.

Mr. **Miller**. That is right. And that $14 billion which goes in our receipts base was the product of reconciliation last year. The 1988 Reconciliation Act.

Chairman **Chiles**. Yes.

Mr. **Miller**. In the President's budget, he proposes a couple of changes in the tax area.

Chairman **Chiles**. That is what I am talking about, those couple of changes.

Mr. **Miller**. A couple of things that go up and a couple of things that go down.

Chairman **Chiles**. Yes, sir.

Mr. **Miller**. But the net is zero. The net of that is zero so——

Chairman **Chiles**. Well, that is good. Then we can propose a couple of changes in this budget, and have some things go up, and we can take some of that money, and offset it over here, and just as long as we come out with zero, we will be all right.

Mr. MILLER. Well, I would not say that just on anything——

Chairman CHILES. You have said it. [Laughter.]

You have said it, Dr. Miller. You have said it.

Mr. MILLER. I did not say that. If I did, I retract it.

Chairman CHILES. I do not know who told it.

Mr. MILLER. No, I said——

Chairman CHILES. I do not know who told that truth.

Mr. MILLER. I said consistent with the budget agreement——

Chairman CHILES. I swear I do not know who told it.

Mr. MILLER. There is $14 billion vis-a-vis the baseline that we were using. That number is there. Again, the very small changes are netted out, so that anything that is a receipts loss is made up with some receipts increase somewhere else.

Chairman CHILES. Well, we will have to see how we can lose a few receipts and make up a few receipts.

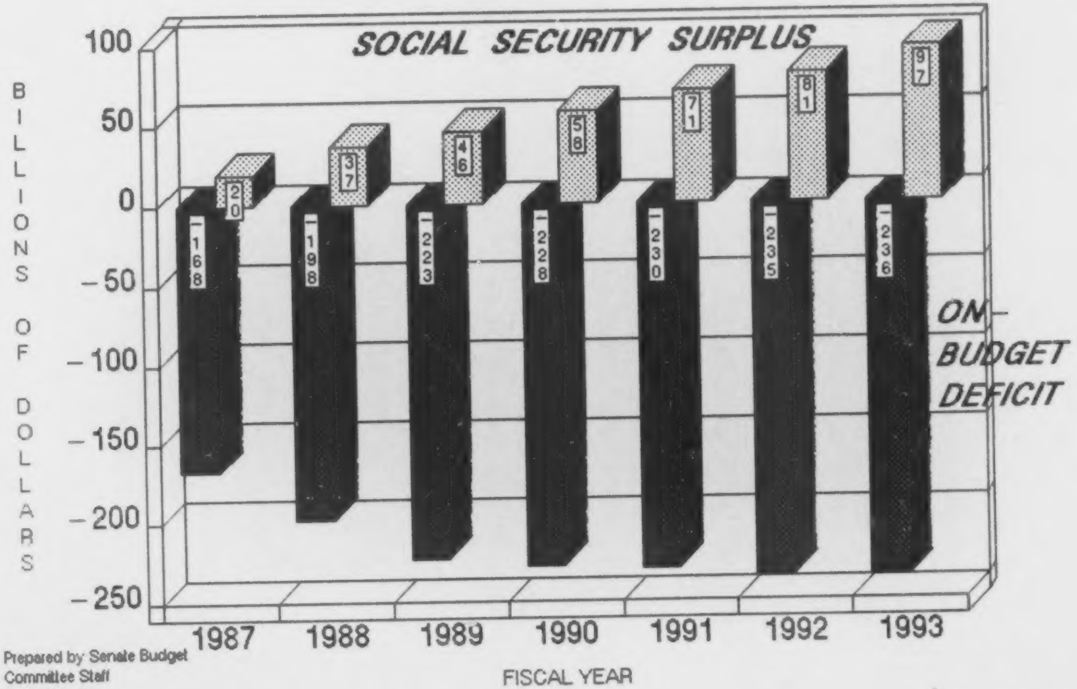
Mr. MILLER. Well, I am sure there will be a discussion over that.

Chairman CHILES. Your documents show that the on-budget deficit in 1988 and 1989 will be about $184 billion. That figure of course removes the social security surplus which masks the size of the real deficit. So even after the past few years of fiscal restraint, our real deficit is still not far from $200 billion.

The on-budget deficit in your forecast declines only gradually over the next 5 years, to $132 billion in 1993. CBO says the on-budget deficit could be more than $230 billion by then.

Whichever of those figures, or somewhere in between, I find that kind of distressing. This chart shows the on-budget deficit, or the Federal funds deficit, and it shows the social security surplus.

ON – BUDGET DEFICIT VS. SOCIAL SECURITY SURPLUS



Prepared by Senate Budget
Committee Staff
CBO Estimates.

We see that surplus building from $20 billion in 1987 to $97 billion in 1993. So that surplus climbs substantially during this period.

Of course we cannot count this surplus to reduce the deficit or to balance the budget. The President has made it clear that social security does not affect the deficit.

Wouldn't you agree that we need to set aside the social security surplus and work toward balancing the on-budget deficit?

Mr. MILLER. Well, I guess if I had my druthers I would rather do that, and that would be to essentially run a surplus on the current account in the coming years. But Mr. Chairman, I must tell you, I find it quite extraordinary for us to have worked so hard through that budget negotiation, for the administration to have worked so hard in pulling together a budget that carries out that bipartisan budget agreement, and then to come up and be criticized, roundly, about the nature of the deficit.

Now if Congress wants to push the deficit down, then is the leadership of Congress saying that they would rather not carry out the budget agreement?

I am very confused on that point.

Chairman CHILES. Some of us still have a nagging conscience. We want to make sure that we do not sort of pat ourselves on the back and say we have solved the problem.

I think some of us want to set the stage for the American people beginning to understand the burden, the problem, the catastrophe that faces an incoming President as he comes into office next year, and whatever party he is in, he had better move awfully quick or we are going to be sunk by these figures.

I think some of us are ready to say that we knew last year, as we were in that budget summit, that whatever we could do we had to do it last year. That this being an election year we were not going to be able to do much more than that.

But at least I think it would offend some of our consciences to say "all is well". All is not well. That chart shows us where the problems are, and I am just asking you if you agree that those are the problems, and that we ought to be dealing with them, that we should not just leave them to a future Congress, a future President. No one should be counting the social security surplus as something that makes the deficit disappear.

Do you agree with that?

Mr. MILLER. Well, there is a problem in what you call the deficit. The deficit is defined by law as the difference between outlays and revenues, which happen to include the trust fund revenues.

I agree that there is, on the other hand, a perception on the part of most people, that the revenues going into the social security trust fund are going to be there.

Chairman CHILES. Let me correct you a little bit on that. Doesn't the law say that you have to separate the two? That it is Gramm-Rudman-Hollings that allows us to put them together.

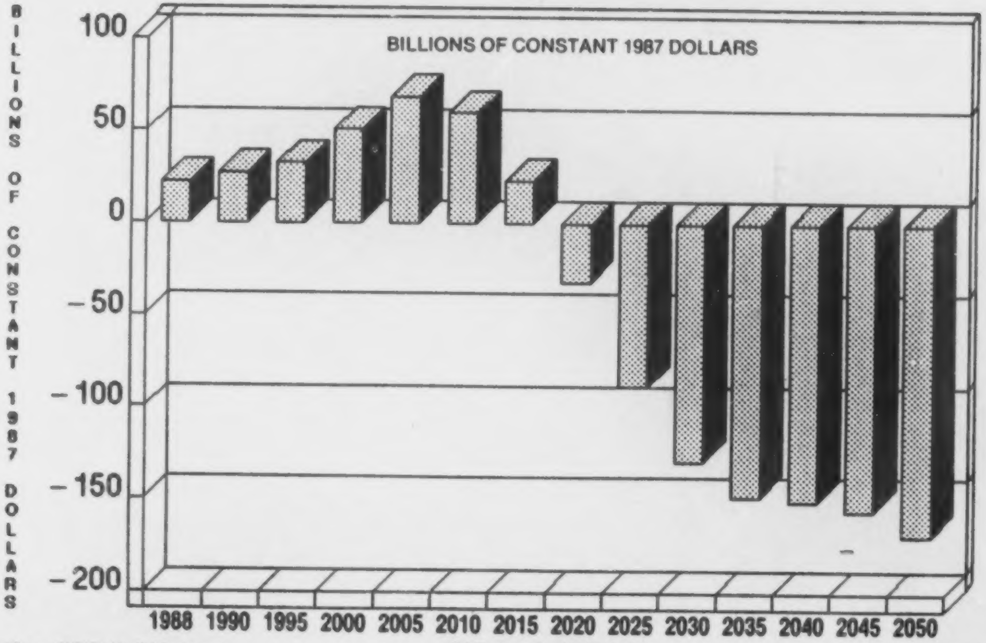
Mr. MILLER. That is what I mean.

Chairman CHILES. All right. So that we are talking about several laws.

Mr. MILLER. The documents that we publish clearly separate——

Chairman **Chiles**. All right. The reason I am concerned about that—if you would show the next chart—we see those surpluses building up, but they do not last forever. If we look at this chart, we will see that those surpluses build up to about the year 2005. They start coming down in 2010. By the year 2020, we are going into a deficit.

SOCIAL SECURITY ANNUAL BALANCE: FROM SURPLUS TO DEFICIT



Data: CRS & Office of
Social Security Actuary

SBC Staff
Feb. 4, 1988

Praise God. I will be hopefully somewhere, the right place, looking down when that happens, and I do not know, you might be here. But our children are going to be here then, and we see those coming down to the year 2050—you know—we see the huge, huge deficits there.

So doesn't that tell us that we cannot count that money as if it were surplus, and we could use it to offset the deficit?

Mr. MILLER. There is no question but that is a problem, and when it comes due and the demographics are such, there are not funds built up in the trust fund. The trust fund is essentially an obligation——

Chairman CHILES. Well, I think that you owe it, and I owe it, and everybody else who was a party to that agreement, owes it as well to the American people to tell them all is not well. We have some major decisions to make, and there is some major medicine to be taken by the American people.

Hopefully it will be administered fairly, so that everybody gets a proportionate dose. It has to be done even though we probably are not going to get it done this year. But we ought to go and fess up and say we are not. Do not try to say all is well, we will grow our way out of this, or any of the other things we have been saying for a number of years.

Mr. MILLER. Mr. Chairman, as I said before at this very table within the last 2 hours, I do not want to whitewash the deficit nor do I want to whitewash the debt, but I think the notion that somehow this President is leaving the next President with a basket case is an extraordinary misreading of the actual evidence.

The next President will be left with a vibrant economy, a situation far better than Ronald Reagan inherited.

Chairman CHILES. A vibrant economy that will project under the deficit we are leaving him, a $4 trillion national debt by the end of his first term.

Now if that is vibrant——

Mr. MILLER. But under this, the President's plan, the national debt held by the public will be less as a proportion of gross national product than it was in President Kennedy's term. Not a very low number, not a satisfactory number, but not disaster either.

Chairman CHILES. When I look at a trade deficit that mirrors the fiscal deficit, and I see what is happening now, and that the Japanese—now Firestone is going to be Finsaki—whatever else they decide to call it—because they are selling out to the Japanese, and we see who has got the money to buy our banks. Look at what the assets of Toyota are compared to the assets of Chrysler. One is about $4 billion and the other is about $50 billion.

And to say all is well—there is just no way we can do that.

Let me move on. Your budget includes $1.3 billion in additional medicare cuts. You justify this by claiming the reconciliation bill last year fell short of the summit agreement on medicare.

We cannot seem to shake a difference of opinion in scoring between your staff and CBO. CBO said we actually got about $500 million more in savings than were required by the summit.

I do not think that you are going to have anyone up here agree that we did not meet the summit agreement in medicare.

For this reason I do not consider additional medicare cuts this year to be very realistic.

Where do you estimate we will be in relation to the Gramm-Rudman targets for 1989 if we do not accept your proposal for more medicare cuts?

Mr. **Miller**. Well, I mean if you do not accept the proposal for more reforms in medicare, then the deficit numbers would go up by the amount that you fail to respond to the President's proposal. Again, I am glad that you did characterize it as a difference in the scoring.

I think, for some very good reasons that we could go into now if you like, the scoring of the administration on that issue is appropriate, and that of CBO is inappropriate.

But I think it is important that we address that problem.

Chairman **Chiles**. Well, that was something you argued to the President as to why he should not accept our scoring last time, as I recall.

Mr. **Miller**. Well, it is something that I told the President when I sat down with him after having something less than 12 hours to review that massive, massive bill that was an all-or-nothing snowball that he had to take or close down the government.

Chairman **Chiles**. Well, the President did not elect to take your advice on that and so——

Mr. **Miller**. Could I just mention, I am told that given—I am sorry to interrupt, Mr. Chairman. I am told that in the calculations that are made to come up with the $142.7 billion deficit that compares with the $146 billion deficit, in determining whether a sequester would take place, that that $1.2 billion in medicare reduction is not included. So it would change the deficit estimate of $129.5 billion, but will not change the trigger on the Gramm-Rudman-Hollings.

Chairman **Chiles**. Senator Nickles.

Senator **Nickles**. Mr. Chairman, I want to follow up on something you said. Mr. Miller, if you would turn to page 6D19 of the budget. I am going to follow up on something the chairman did, and also that Senator Riegle did, and I do not often agree with Senator Riegle.

But I was doing a little homework after he made his statement about the—I want the chairman's attention on this because he made a very good point about social security.

Social security, under the budget, is going to have a $45 billion surplus, and so if you add that to it, certainly, the deficit is worse as far as an operating deficit. But you should also actually add in $67 billion on top of that.

The actual operating deficit would be—if you took all the trust fund accounts out, expenditures and receipts, in all the trust item accounts, you have a deficit for the year projected in 1989 at $242 billion, and the year just completed, $244 billion.

Correct me if I am wrong, but I think that is exactly accurate. And so you have a total for the year, in 1989, of $112 billion, that is a trust fund surplus that really camouflages the severity of the problem. I will be frank. I have been on this committee now for 2 years, and I have wrestled with budgets probably as much as anybody, but the trust fund accumulations really do mask the real significant and serious problems that we have.

Do you disagree that there is a $112 billion surplus coming from the trust funds?

Mr. **Miller**. Well, in toting it up that way that is correct. Keep in mind that, again, it depends on what you count as the deficit.

If you count, as we normally think of it, as the difference between governmental revenues and governmental outlays, then the number that we use for purposes of Gramm-Rudman-Hollings, the $129.5 billion, is the correct number.

If you exclude everything in the Trust Funds, yes, the deficit on current account is higher.

Senator **Nickles**. Well, it is actually much higher.

Mr. **Miller**. It is much higher.

Senator **Nickles**. The $240-some billion, that concerns me. Actually, correct me if I am wrong, the way the fiscal affairs are handled, there is no real trust fund, period. Aren't all funds—social security, civil service, military retirement—aren't all funds put into one big pot? And all payments are paid out of one big pot?

Mr. **Miller**. That is right.

Senator **Nickles**. Do you think the American people would be surprised, and social security recipients, when they have this misconception that they have a separate trust fund that is accumulating interest and building up?

Do you think they would be surprised when they find out that actually those funds are spent just as fast as they go in? They are in the same pot as everything else?

Mr. **Miller**. Probably so.

Senator **Nickles**. I would hope—and Mr. Chairman, I respect your leadership—I think we need to get that fact out, because I can tell you from some town meetings. Senator Conrad mentioned his, I have had some, too, and there is a real gross misconception concerning trust funds, whether it be civil service—"wait a minute, I've been paying into this trust fund, it's accumulating interest, and now I get my money back." Or social security, "I know my money's been drawing interest."

And they have this idea that every trust fund is their own independent IRA of some kind, and I think it is grossly misleading.

Granted, if it all comes out to the net, next year we might have a deficit of $129.5 billion, as you propose, but the real operating deficit is—if you take all trust fund accounts out—is $240 billion, and that bothers this Senator. It bothers me a lot.

And you know, everybody talks about the agreement and whether it is satisfactory or not satisfactory. I think it left a lot to be desired, and I compliment the chairman because he has made this comment time and time again, usually just pertaining to social security.

But I looked on the special analysis section of the breakdown of the other $67 billion, and, you know, a big part of that is health insurance trust funds.

It has a significant surplus of about $24 billion projected for 1989, and I know that there is demands coming on that, as everyone else is aware of, because of demographics, because of Congress, because of potential catastrophic health insurance, et cetera.

State highways. Retirement. The demands on these trust funds are there. The demand on social security is there, as that one chart so graphically displayed.

The bill is going to be coming due, and I am worried about not so much maybe my generation, but my children's generation are really going to be there when that hits the fan, and the burden is just going to be astronomical.

So I would really hope that we would—if we do not do anything else, start educating people and maybe be truthful and say there is no social security trust fund. There is no medicare trust fund.

There is no civil service trust fund. There is no government employees' trust fund. Those are nothing but paper entries. And maybe if we would make that fact, and tell them that we have spent the money, plus another $130 billion on top of everything that came in, maybe we would be a little bit more honest.

Is my characterization of that accurate? Am I misinterpreting something?

Mr. MILLER. I am not sure that I would say it exactly the way you have said it, Senator, but the point is well-taken. There is a difference between the operating deficit which excludes trust fund accounts, and the one that includes trust fund accounts.

Senator NICKLES. Well, let me be explicitly clear. Is there a social security trust fund that is separate, that is accumulating money, separate from all other government accounts?

Mr. MILLER. And the answer is no.

Senator NICKLES. The only thing we have, basically, is paper entries that we put in each year. Let me make one final comment on a different subject. I related to you——

Mr. MILLER. The accounting is kept spearate, but do we take funds and go put them in a safe somewhere? The answer is no.

Senator NICKLES. You know, I ran a manufacturing plant for years, and we had our accounts. We had retirement accounts and we put money into separate funds for the employees, and it was there whether the company went bankrupt or not. It would be nice to have that. We don't have it now, and I think that's a misconception.

Mr. Miller, I referred earlier to the line-item veto, and some articles that have been in the Wall Street Journal. Let me urge you to do that. You are in a position to take the initiative. I have been reading in the Constitution, Article I, Section 7, the third paragraph:

> Every order, resolution, or vote to which the concurrence of the Senate and the House of Representatives may be necessary shall be presented to the President of the United States, and before taking effect shall be approved or be disapproved.

That has not been exercised. It is time that it be exercised. It is time that it be tested. It will not be tested unless you direct the President and encourage him to do so, and I encouraged you to take that leadership several times. And it does not have to be on an appropriations bill, it can be on legislation as well. Thank you.

Chairman CHILES. Senator Conrad, do you have further questions?

Senator CONRAD. I do, Mr. Chairman. I would just like to return to this chart which shows the combination of the on-budget deficit, and the social security surplus. [See p. 137.] My question to you, Jim, is: do you think this is a responsible pattern?

Mr. MILLER. Well, look, if you look around the room I doubt if you will find any more hawk on the budget deficit than Jim Miller. I would like very much to reduce the budget at a much faster rate than we have agreed to. I sat in the room and advocated a number of initiatives that would have reduced the deficit at a much faster rate.

But after 20 days and 20 nights of negotiations, in a bipartisan fashion we reached an agreement over a 2-year budget deficit reduction package. A deal is a deal, and I am carrying out our part of our bargain by being here. The President is——

Senator CONRAD. What if it is a bad deal for the people that we all work for, the American public? In your judgment—I am asking Jim Miller—do you think that is responsible?

What I hear you saying is, "no, it is not responsible," and if that is the case, shouldn't we go back to the agreement this year—let's not wait. Why should we stick to a deal that is a bad deal for the people we work for?

Shouldn't we go back, and aggressively move to reduce this deficit?

Mr. MILLER. Well, again, these are out-years. I mean, the budget deal covers 1988 and 1989. The year 1990 is a different year. The President may propose substantial changes in his 1990 budget. I realize it is a budget that will be overtaken by events, but there may be proposals there.

I am sure that there will be proposals by Members of Congress. We worked very hard to come up with a deal. It did not satisfy everyone. I am sure the budget deal did not satisfy Chairman Chiles in every dimension. It did not satisfy me in every dimension. It did not satisfy the President of the United States in every dimension. A deal is a deal, and that is what we are carrying out.

Senator CONRAD. But isn't it a bad deal? Let's be honest with each other and with the American people.

Mr. MILLER. I am always honest.

Senator CONRAD. Let's be honest. This is not responsible. In fact, we both know, this is totally irresponsible. Senator Nickles made a powerful point: we are not doing what we ought to be doing. We are digging this country a terribly deep hole. We have an obligation to go back this year and get serious about what we are leaving the country.

Wouldn't you agree that we ought to make changes this year?

Mr. MILLER. Senator Conrad, I want the record to clearly reflect the fact that I am here representing the President, and the President's position is 100 percent in accord with the budget agreement. But if I might make a suggestion to you. When, next week, the President sends up a package of identified items in the CR that he would have x'ed out, he would have lined out, if he had the line-item veto, you will have an opportunity to vote on a package of low priority. I think many people would agree, from the discussions——

Senator CONRAD. How much are we talking about in that package?

Mr. MILLER. That has not yet been determined.

Senator CONRAD. That is going to be nickles and dimes, right?

Mr. **Miller**. Can we count on you for your support?

Senator **Conrad**. But that is going to be nickles and dimes. I am talking about the fundamental pattern here. I think Senator Nickles——

Mr. **Miller**. If we have the first nickel and the first dime——

Senator **Conrad**. Senator Nickles——

Mr. **Miller**. Can we count on you for support of that——

Senator **Conrad**. Well, I do not know what the priorities are going to be, but Senator Nickles I thought made the point very well. The truth is that the operating deficit of this country is much larger than we are telling people. In fact the operating deficit is increasing in this country.

The fact is that agreement that was made last year does not do diddly. I honestly believe, Jim Miller, sitting there, would be the first one, or among the first to stand up and say amen. We immediately should move to do something about this trend.

Mr. **Miller**. Can we do something about agricultural entitlements that are over twenty——

Senator **Conrad**. I tell you, last year I proposed an across-the-board cut. We got 36 votes, 18 Democrats, 18 Republicans. Do you know who voted for it? The heartland Senators. Chuck Grassley, sitting right there, voted for it. Don Nickles, sitting right there, voted for it. I voted for it. The chairman voted for it.

We cut everybody, and I am ready to do it again. But I mean everybody. I do not mean this is off the table, that is off the table, revenue is off the table. I want to reduce this deficit.

Mr. **Miller**. Was it a freeze, or what was it?

Senator **Conrad**. No, a cut: 2-percent cut right across the board.

Mr. **Miller**. Yes, but vis-a-vis current services, that would be an increase for an agricultural entitlement, would it not?

Senator **Conrad**. Oh, no. We were cutting agriculture. We did not play any funny games. We cut agriculture.

Mr. **Miller**. Wasn't agriculture going down under the——

Senator **Conrad**. And we cut from the budget resolution. We played none of those games. It was not a freeze. It was a cut from budget resolution numbers. So it would have cut agriculture along with everybody else. And that is what has got to be done. I am just appalled at what I hear here today.

When you talk about leaving the country a vibrant economy, you are talking about leaving the country and economy pumped up by the most massive deficit spending in the history of mankind. That is why it is vibrant.

Mr. **Miller**. Senator Conrad, that is simply not true.

Senator **Conrad**. Oh, it simply is true. Do you deny that we have had the largest increase in the deficit of any government in recorded history?

Mr. **Miller**. The nominal deficit, that is correct, but could I direct your attention to page E9 of the special analysis, and you will see there, in 1955, for example, the national debt was——

Senator **Conrad**. Percentage of GNP. I know that story. I am talking about the trend here. At the end of World War II we were at 120 percent of GNP.

Mr. **Miller**. Well, let's don't teach it round one time and flat another. I mean, if——

Senator CONRAD. Well, let's talk about the trend. Let's talk about what's happened in the last 7 years.

Mr. MILLER. OK. The last 7 years, the debt as a proportion of gross national product rose, but for the first time this year, for fiscal year 1989 it will fall, and it will continue to fall under the budget agreement, and under the——

Senator CONRAD. Wait a minute. What numbers are we using? Are we using the trust funds?

Mr. MILLER. The debt held in the public hands.

Senator CONRAD. All right. If we are talking about the debt, which is what we have been discussing here, we all know what is happening. It is rising, and it does nothing but keep going up. If we were serious about what our obligation is——

Mr. MILLER. The odometer rises also.

Senator CONRAD. So is your position, then, we ought to just stick with the agreement that that is plenty good enough?

Mr. MILLER. My position is, having been the product of these 20 days and 20 nights of negotiations, and Senator Chiles will affirm to you that some views that I had were not necessarily adopted in the budget agreement, but nevertheless, a deal is a deal. The President and the leaders of Congress agreed to it, and to carry it out.

Chairman CHILES. Senator Grassley.

Senator GRASSLEY. Mr. Miller, I want to continue where I left off when I had to go to another committee meeting, and I did have an opportunity, while I have been waiting here to discuss with you your figures versus what we estimated the real deficit would be. And again, this gets back to the problem that I think we have of rosy projections, and that creates a problem.

I want to contrast——

Mr. MILLER. But Senator Grassley, last year we were not rosy enough, and you used the same methodology this year as last year.

Senator GRASSLEY. OK. Last year, I have here, for the last 4 years, on 1984, actual over-projection you were a plus 3.5 percent—or I mean, $3.5 billion. In 1985, you were minus $31.9 billion. In 1986, minus $41 billion; last year, minus $6.4 billion.

So I was leading up, you know, to where you would suggest cuts, and it was to set up that hypothetical case, but with three crystal-clear choices, and you gave me your choice that you would suggest making additional cuts. You said you would not raise taxes, so that leaves spending cuts.

And you said, though, that the hypothetical would not actually transpire. And I do not think that you would disagree that OMB, from these figures I gave you, have under-estimated the deficit more in the recent past, and more than once.

And so I think that gives plausibility to the hypothetical question, and that is why I ask you for a forthright response.

And I think that that forthright response can be a little bit along what you, the comments you were making to Senator Conrad, that you were arguing for more cuts last year than what the conference committee suggested.

So if you are going to get to a point where you could be, in August, $20 to $30 billion worse off than what we are, then I would like to know where you would recommend cuts. In entitlements? In defense? Nondefense, discretionary, in agriculture? Where?

Mr. **Miller**. Senator Grassley——

Senator **Grassley**. Maybe even across the board.

Mr. **Miller**. I mean, if we reach that point, I think we would entertain a variety of possibilities, but I am just not prepared today to go into any detail as to how we would achieve such savings. Again, it is hypothetical. We think that the budget—that what the President has proposed here will avoid a sequester and we will get the deficit down in the neighborhood of the figures that we have described.

I think it would be counterproductive, from our standpoint, to speculate at this point on what the President might do if it did happen that the deficit figures looked more pessimistic this coming summer.

Senator **Grassley**. Well, I think one thing you did say, though—and conservatives are very concerned about this—that you are not going to be asking for a tax increase?

Mr. **Miller**. What I reflected upon is if we reached that point I doubt the President would propose as a way of additional savings, that it be a tax increase.

Senator **Grassley**. Yes. Could I change direction, Mr. Miller. I want to deal just a little bit with the issue of asset sales.

I think you are proposing $10 billion. The criteria is what I am interested in, that you might use to select which assets might be sold.

And let me also suggest that this is where I am coming from. I want to have you reflect upon whether these sales reflect a well-thought out policy, a policy of what ought to be sold, or whether that it is kind of the ease of sale, getting at sales that will bring in the amount of money that you want.

Mr. **Miller**. Senator——

Senator Grassley. And that is not a critical comment.

Mr. **Miller**. Yes; Let me answer it. We have about $10 billion in asset sales. We have some repayments. Of the $10 billion, roughly a third is prepayment of REA loans which we opposed, and prepayment of FMS, foreign military sales paper.

One-third of it is the sale of the loan assets, going back to this colloquy I had with Senator Conrad, and, about a third of it is the sale of real assets, privatization.

Let me just take the privatization. We do not need that money to lower the deficit because we are well below the $136 billion. In fact we are $6 billion, $6.5 billion below the Gramm-Rudman-Hollings' target.

The sale of those hard assets, the real assets, and the sale of those loan assets, they do not count against the $146 billion trigger of Gramm-Rudman-Hollings, the sequester trigger. So we do not need that money to lower the deficit, or to get within the Gramm-Rudman-Hollings, or to avoid a sequester.

We are proposing those sales because it is good policy, it is good government policy to spin those assets off. We expect about $3.2 billion from the sale of the naval petroleum reserves. We have, in the strategic petroleum reserve, far more oil that could be drawn out at a much faster rate than ever could be accorded from the naval petroleum reserves.

In terms of a portfolio of assets to do what the government needs to do, it makes no sense to continue to hold on to naval petroleum reserves, and that is the reason that we are proposing to sell those in the private sector.

Senator GRASSLEY. Well, 1 and 2 years ago, didn't the money coming in be considered for meeting Gramm-Rudman targets?

Mr. MILLER. Last year, I believe, in order to meet the $108 billion, target the sale of the NPR was necessary. That would have been necessary. That was before Congress amended the law, Gramm-Rudman, so-called Gramm-Rudman-Hollings II, and excluded those from the calculation of the number you compare with the target plus ten.

Senator GRASSLEY. Well, what was the policy for those periods of time, then, when the purpose of it was to reduce the deficit?

Mr. MILLER. Well, the purpose then was not—it served both purposes, and as I have said repeatedly, in those situations, that even if we did not have a deficit, we would be proposing to make those—we would be proposing those privatization initiatives.

Senator GRASSLEY. OK. Now were those sales, at that time, made on ease of sale, or did they fit into this overall philosophy?

Mr. MILLER. They fit in the overall philosophy. What we did, Senator—and we have accelerated the process. We have an associate director of OMB that concentrates on privatization initiatives. We have a subcommittee of the economic policy council, or the Domestic Policy Council, that looks at this, and as you know, the President has appointed a Privatization Commission which will be making its report in about a month or so, looking at these issues in a very organized way, in a way that talks about the correct public policy, and how to phase these changes in.

And from time to time we adjust that portfolio just a little bit, but it is driven by good public policy.

Senator GRASSLEY. Well, in the case alone, then, what sort of safeguards do you have in that policy to see that there is not what you might call a creaming of the loans, where those that are most lucrative and easily sold will be sold off, leaving the government holding the bag with those that are not worth as much?

Mr. MILLER. There is some choosing of the portfolios. Those that are in better shape, in terms of the information, where we think that the private sales are going to yield the best return to the government. There is some choosing of that, but we sell the whole portfolio, and we sell it without recourse.

That is to say, we sell it, and whoever purchases it cannot come back to the Federal Government and say, hey, I cannot collect this loan, you have to absorb the bad ones.

Chairman CHILES. I want to follow up on that.

Senator GRASSLEY. Go ahead.

Chairman CHILES. And I thank the Senator for opening this line of questions. Last year, the administration was successful in selling loans and implementing prepayment programs to achieve $7.4 billion in receipts for 1987.

Considering the magnitude of the sales, I was favorably impressed that the agencies were able to put together workable programs in such a relatively short period of time.

I do, however, have some concerns about the creation of senior and subordinated loan offerings, where the Federal Government ends up retaining the subordinated class of loans for up to 2 years.

When the government retains this subordinated class of loans, interest and principal payments that ordinarily would flow to the Treasury can be claimed by the holders of the senior class loan. In other words, receipts due to the government are used to guarantee, albeit in a limited sense, payment to private investors.

That seems awfully much like a recourse loan sale to me. Do you agree with that?

Mr. MILLER. Mr. Chairman, let me, if I could, get back to you a written answer on that point.

[The following was subsequently supplied for the record by OMB:]

SPECIAL PURPOSE ENTITY

Each of the 1987 pilot asset sales was structured using a Special Purpose Entity (SPE). The SPE's purchased loans from the participating agencies and in turn issued multiple series of debt obligations. The sole source of income for the SPE is the cash flow derived from the loans sold to the trust. This income is then passed through to the holders of the debt obligations according to the stated terms of the obligations.

The financial advisors recommended the use of two classes of securities, a senior class and a subordinated class. Governed by a repayment schedule, the senior class would have first claim on the income generated by the SPE with the subordinated class having a secondary claim. They recommended this structure because they felt it was important to obtain the highest rating for these obligations given the novelty of attempting to sell nonrecourse loans to the private sector and in order to generate the highest sales proceeds to the Federal government.

The Federal Government sold loans to the SPE's for cash. In two cases the government also received the subordinated debt obligations as well which can be sold at some time in the future. The debt obligations received have value, in that they represent an interest in the income generated by the SPE. The Federal government is entitled to receive receipts generated from the loans sold only to the extent defined by the terms of the subordinated debt obligations owned.

The senior/subordinated structure does not represent a recourse sale because the Federal government has removed future liability in the event of default of borrowers by selling the loans to the SPE.

Mr. MILLER. That practice was responding to, as I recollect, some very expert advice that we received on the best way to maximize the final return.

Chairman CHILES. Well, you have been up here, and we have both talked about getting a credit reform budget. It seems to me that if we are talking about adopting credit reform we need to look at these, and if it is a loan guarantee we ought to call it a guarantee. I have helped resist the House putting in what amounted to guarantees in the veterans' loans that they were talking about selling.

Mr. MILLER. Yes; I remember.

Chairman CHILES. If the senior-class loans are sold, but the subordinated-class securities are not, doesn't that practice have the effect of enhancing the market value of the loans that are sold, since those loans are backed up by a subordinated class of securities?

Doesn't the Government's holding of the subordinated class distort in effect the subsidy value of the loan?

That is one of the reasons for having loan sales, to really truly determine what the heck the subsidy value is.

Mr. **Miller**. Right. Yes; well, let me get back to you on that point.

[The following was subsequently supplied for the record by OMB:]

SENIOR/SUBORDINATED STRUCTURE

The senior/subordinated structure was developed to enhance the value of the senior structure. However the fact that the Federal government did not sell the subordinated securities in two cases has no bearing on the market value of the senior securities. They would have the same value regardless of who owned the subordinated class.

In a pure sense, holding the subordinated class can distort subsidy estimates, however, as occurred in the 1987 sales, with assistance from the financial advisors, the market value of the subordinated class can be estimated.

The sale of loans under the 1987 pilot program has helped develop the market for future Federal loan assets. However, estimating the subsidy from these sales of older loans poses a problem due to interest rate changes that have occurred between the time when the loans were granted and when they were sold. Nonetheless it is the sale of loans that provides the most accurate estimation of subsidies. The competitive market will assign an unbiased present value to the cash flows that will be generated over the life of these loans, given that investors have adequate information and liquidity exists for the resale of the assets.

Selling new loans as soon as or shortly after disbursement is a method of eliminating the interest rate differential that is an inherent drawback in selling older loans. The 1987 pilot program has helped to lay the groundwork for improved knowledge and liquidity for the private investor to enable the market to correctly assign a value to Federal loan assets. To the extent possible, the sale of new loans will be emphasized in the 1988 and 1989 sales.

Although providing information that will help in the estimation of the subsidy is one of the objectives of loan asset sales, another is the accomplishment of credit management improvements. These benefits are already becoming evident:

Administrative costs, especially for terminated and small programs, will be reduced;

Motivated by the close examination of portfolios necessary to accomplish sales, improvements in the origination and documentation of Federal loans will occur—thereby lowering defaults.

Deficiencies in information systems used to track lown repayments have been identified and will be corrected.

Chairman **Chiles**. I would like you to tell me why we are holding on to rural housing, and the Department of Education subordinated loans. If you are unable to sell the subordinated-class loans, I would like you to tell me why that does not suggest that we should stop selling loans using this structure.

Alternatively, if a two-class structure is the only way you can sell a loan, does it make sense to keep selling loans at all if you cannot get a decent price for the Class B security?

In other words, what I am saying is, if you have something that amounts to some kind of a guarantee, you are really distorting the sale you are getting on the Class A.

Mr. **Miller**. I see your point.

Chairman **Chiles**. Those sales look good.

Mr. **Miller**. Yes.

Chairman **Chiles**. There are no fire sales.

Mr. **Miller**. Yes. I see.

Chairman **Chiles**. But if the fire sale is coming with the Class B, that either we have got to sell some time in the future, or we are not going to sell, then we are distorting the heck out of it.

Mr. **Miller**. Let me look into it and get back to you.

Chairman **Chiles**. I would like to have your answer on that.

[The following was subsequently supplied for the record by OMB:]

We are holding on to the RHIF subordinated class because review of the loan documentation has not been completed so that the loans themselves have not been fully identified. Additionally servicing of the loans sold will not be fully privatized for at least one year; investors, therefore, would focus not on the true value of the subordinated class but on the uncertainties surrounding the transfer of servicing. A fair value for the securities would not be received.

The Education Department retains the subordinated class upon the advice of its financial advisor in order to give it time to establish a cash flow history that would enable investors to determine with greater precision the value of this class and receive fair value. We want to avoid selling these securities at "fire sale" prices.

The subordinated securities can be sold. The Rural Development Insurance Fund subordinated security received an A-rating from Standard and Poor's Corporation and its sale closely followed that of the senior securities.

The senior/subordinated structure is not the only way to sell loans, but given the financial community's push toward standard packaging of securities and the widespread use of other types of overcollateralized issues, this type of structure is familiar to investors and represents an effective nonrecourse means by which the Government can maximize the proceeds on these sales.

Senator GRASSLEY. Let me also say that that follows a line of questioning that I was going to pursue. I only have one other point, then, along the same line, and this would involve, like we will say, loans to municipalities, as an example, or political subdivisions.

Some of those are sold. Why don't we offer the municipality an opportunity to buy those at a discount rate, or at least to buy them back from the person who would buy them, so that there is not a lot of arbitrage benefit?

Mr. MILLER. Well, Senator, I mean, do you want to subsidize the entity twice? I mean, if you give them a loan and you are giving it at a favorable relationship to the private sector, and then you want to turn around and sell the loans and give them a discount, you will be subsidizing them twice.

Let them purchase it in the private market, as they wish.

Senator GRASSLEY. OK. Well, let's suppose you discounted 35 percent.

Mr. MILLER. No, what we do is, we put the loans out on a competitive basis.

Senator GRASSLEY. OK.

Mr. MILLER. Yes. Basically, that is the way it works. You sell it to the highest——

Senator GRASSLEY. OK. But let's suppose they end up at a sale, of 20 percent, and the municipality was willing to do that for 18 percent. The Federal Government would be 2 percentage points ahead.

Chairman CHILES. Pardon?

Mr. MILLER. Say that again.

Senator GRASSLEY. I said then the municipality would be 2 percentage points ahead—the Federal Government would be 2 percentage points ahead.

Mr. MILLER. If they did what?

Senator GRASSLEY. Well, if those went out on a bid basis, we will say, and the end result was a loss of money to the Federal Government of 20 percent, and the municipality could handle that, we will say, at 18 percent, the Federal Government would be ahead.

Mr. MILLER. But if the government sold the loans to the highest bidder and the municipality was willing to buy them at a higher price, then they would get them.

Senator GRASSLEY. They have that opportunity today?

Mr. MILLER. Sure. They have that opportunity.

Chairman CHILES. Mr. Miller, this year the President's budget lists five new government-sponsored enterprises. That is the same number of off-budget corporations that it took the previous 70 years to establish.

In addition to the sheer number of off-budget enterprises, many of these new corporations have missions that are significantly different from their predecessors, those that we started before.

Although all of these institutions meet the technical difference of a private enterprise, in a couple of instances we have set up off-budget corporations whose sole purpose is to bail out existing Federal-established institutions.

That role differs markedly from the traditional government-sponsored enterprises we have established to channel credit to certain specific sectors of the economy.

For instance, a financing corporation was established to bail out the Federal Savings and Loan Insurance Corporation, and a Farm Credit System Financial Assistance Corporation was enacted to guarantee interest and principal payments on farm credit system obligations.

Those two entities alone represent a current liability of more than $14 billion. This off-budget spending trend concerns me because the bottom line is, what we are doing is creating vehicles to engage in billions of dollars of Federal credit activities that ought to be scored on budget.

I can tell you from what I hear there are a number more planned this year. Everybody has decided this is a good thing.

Do you share my concerns regarding so many of the new off-budget credit enterprises, and are you concerned that somewhere down the line, the Federal Government may have to shovel out a lot of cash, if these entities end up in financial difficulty?

Mr. MILLER. I surely am. I am glad you clarified it. The GSEs that we have in the budget are those mandated by law. It is not a new proposal from the administration, but I agree with your point.

Chairman CHILES. In the budget appendix, then, I noted that there is no data regarding projected income and expense liabilities, net worth, borrowing requirements, and related financial information for the newly created farm credit GSEs, or the College Construction Loan Insurance Association.

That is sponsored by all other government-sponsored enterprises. So not only have we taken these corporations off-budget, but, in addition, I find the details on their projected activities are not spelled out in the President's budget.

I can understand not having complete information, perhaps, on the farm credit enterprises since they were only authorized a couple of months ago. But the College Construction Loan Insurance Corporation was authorized in 1986.

Why don't we have any financial data on this government-created activity?

Mr. MILLER. Because they would not give it to us.

Chairman Chiles. They would not give it to you?

Mr. Miller. They would not give it to us.

Chairman Chiles. You do not have the right to get it from them?

Mr. Miller. No; give us the right, Mr. Chairman. Give us the right. You will see action.

Chairman Chiles. Then there is no way we can monitor the operations of a federally chartered corporation. No financial statement is provided to give us a breakdown of the current and projected financial activities for the coming year.

You are saying OMB does not have the right?

Mr. Miller. Do not have that right. They do not even admit they are a GSE.

Chairman Chiles. They do not admit they are——

Mr. Miller. A government-sponsored entity. We need some help.

Chairman Chiles. But they have a siphon into the Federal Treasury, do they not?

Mr. Miller. Indeed they do.

Chairman Chiles. And they admit that they have that, do they not?

Mr. Miller. Yes.

Chairman Chiles. And they are ready to suck on the siphon, are they not?

Mr. Miller. That is right.

Chairman Chiles. Thank you. We thank you very much for your appearance here today.

Mr. Miller. Thank you, sir.

Chairman Chiles. We stand adjourned.

[Whereupon, at 12:28 p.m., the committee was adjourned, subject to the call of the Chair.]

1125 Fifteenth Street, N.W.
Washington, D.C. 20005

Mortgage Bankers Association of America

Burton C. Wood
Senior Staff Vice President
and Legislative Counsel
202-861-6507

March 31, 1988

The Honorable Lawton M. Chiles
Chairman
Committee on the Budget
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Mortgage Bankers Association of America (MBA)* appreciates this opportunity to present its views on the Administration's FY 1989 Budget Proposals on Federal mortgage credit programs. Our comments focus on proposals affecting the Veteran's Administration home loan guaranty program, the Federal Housing Administration (FHA) mortgage insurance programs, and the Government National Mortgage Association (GNMA) mortgage-backed security (MBS) guaranty program.

MBA requests that the Budget Resolution assure adequate funding for these programs. MBA also requests that the Committee adopt adequate credit budget limitations for the FHA mortgage insurance and GNMA-MBS guaranty program. In addition, MBA voices its strong opposition to the Administration's and others' proposals to revise budgeting for Federal credit programs to reflect "estimated subsidies" supposedly associated with these programs. MBA has serious concerns about the effect of these proposals on the mortgage credit programs and requests that the Committee hold hearings before proceeding to consider the Administration's proposed credit reform legislation or any other alternative proposal.

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*The Mortgage Bankers Association of American is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators and servicers, as well as investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

Appropriations for Mortgage Credit Programs

The VA Home Loan Guaranty program is an entitlement program established under the Servicemen's Readjustment Act of 1944 to help qualified veterans achieve homeownership. As an entitlement, program activity is not limited, and all veterans who apply for and qualify for the program will receive a home loan guaranty. Appropriations to cover default losses as they occur are subsequently provided in appropriations bills.

The President's Budget requests FY 1989 appropriations of $653 million for the VA Home Loan Guaranty Revolving Fund, which is the primary financing mechanism for paying claims under the home loan program. Sources of funds include a one percent loan funding fee paid by the borrower, a new one-half percent fee paid by those assuming loans, income from the loan portfolio, receipts from the sale of vendee loans (direct loans made by the VA to finance the sale of VA acquired properties), and, when required, direct appropriations.

Because of severely depressed economic conditions in some parts of the country, there has been a significant increase in recent years in the number of foreclosures of VA loans and in the losses incurred by the Revolving Fund in the acquisition of foreclosed properties securing guaranteed loans. As a result of these losses, appropriations are required. MBA respectfully urges that the FY 1988 Supplemental Appropriation request for $526 million, and the $658 million required in FY 1989 be provided.

The Administration's FY 1989 budget states that beginning in the second half of FY 1988, all loans will be sold without recourse, and that by the end of FY 1989, the VA will sell $861 million of its loan portfolio. P.L. 100-136, enacted on October 16, 1987, effectively requires the Administration to sell vendee loans with recourse because loans can be sold without recourse only for the amount of the loan's unpaid balance. MBA opposes sales without recourse because they would not be in the best financial interest of the Fund in the long or short term. The sale of vendee loans without recourse shifts the credit risk to private purchasers, who necessarily adjust their purchase prices down to reflect this higher risk. It can be expected that the reduction in the sales price paid to the government will be greater than any savings it might realize by transferring the risk of default.

The Federal Housing Administration single-family mortgage insurance programs are actuarially sound insurance programs in which borrowers pay insurance premiums when obtaining a loan, that are set to cover the costs of program operations, defaults and claims. As a result of these user paid premiums, no Federal appropriations are needed.

The GNMA-MBS program provides a means for homebuyers, primarily moderate- to middle- income families and veterans, to obtain competitive direct access to the capital markets via the secondary mortgage market. GNMA guarantees timely payment of principal and interest on securities backed by pools of FHA-insured and VA-guaranteed mortgages. Receipts from guarantee fees and miscellaneous sources are more than adequate to cover the administrative expenses of the fund. The unobligated balance of the fund is projected at $1.7 billion at the end of FY 1988. Consequently, no appropriations are required beyond the release of current resources to cover administrative costs and defaults.

Federal credit programs, such as FHA and GNMA, for a number of years have been subject to a "credit budget," which separately tracks and limits commitments in these programs. The VA home loan guaranty program as an entitlement, has not been subject to these ceilings. The credit budget is included in this year's annual budget submission and is also addressed in the House Budget Resolution.

MBA believes that credit ceilings are counterproductive in demand driven programs, such as the FHA insurance, VA home loan guaranty, and GNMA-MBS programs. MBA urges Congress to exempt FHA and GNMA from credit limitations. However, if Congress chooses to establish credit limitations for the FHA and GNMA programs, MBA urges Congress to set those limits at levels adequate to accommodate demand.

In addition, MBA urges the Committee to exempt the FHA and GNMA credit limitations from the Gramm-Rudman-Hollings sequestration process, which subjects programs to across-the-board cuts when deficits exceed projected levels. Most of the Federal insurance programs, e.g. the Federal Savings and Loan and Federal Deposit insurance programs are already exempt from sequestration.

For FY 1989, the President's budget proposes that commitment authority for the FHA mortgage insurance program be set at $75 billion. This is significantly less than the $96 billion FY 1988 level. MBA expects that the FHA program will experience strong consumer demand in FY 1989 as a result of the continued stability of interest rates and interest in refinancings. Therefore, MBA urges the adoption of a FY 1989 limitation of at least $104 billion, the level in the FY 1989 authorization.

For FY 1989, the Administration proposes that commitment authority for the GNMA-MBS program be set at $100 billion, compared to the $144 billion level enacted for FY 1988. Again, because GNMA provides a secondary guaranty on FHA loans and the VA loans, which are entitlements, a low limitation on GNMA artificially restricts those programs. MBA urges adoption of the level in the authorization, $156 billion.

Credit Reform Legislation

The FY 1989 budget indicates that the Administration is once again submitting a legislative proposal that will attempt to identify the "grant equivalent subsidy" of Federal credit programs. Legislation proposing changes in budgeting for Federal credit programs, the "Federal Credit Reform Act of 1987"(S 745, HR 1754, hereinafter referred to as the "credit legislation", was sent to the Congress last March. That legislation, which MBA presumes will be substantially similar to the legislation to be transmitted later this year, proposed dramatic new Federal credit program restrictions.

The alleged purpose of this legislation was to consolidate management of all Federal credit programs within the Treasury Department and to impose budgetary requirements and controls that would limit the role of Federal credit programs. However, MBA believes that a disturbing objective of the proposal was quantification of the claimed "implicit subsidy" for Federal direct loan, guaranty, and insurance programs. As described below, the "grant equivalent subsidy" under even the expected revised credit legislation would result in large requests for budget authority and appropriations, which must be approved by Congress before any loans could be made, insured, or guaranteed. MBA believes these budget authority requirements would place pressure on Congress eventually to decrease credit program activity or increase or establish fees to offset those appropriation requirements.

MBA does not question that there is value in a Federal credit program in facilitating the flow of funds to particular borrowers. One component of that value is the market efficiency that results from standardization, homogeneity, and volume, and is particularly applicable to mortgage credit programs. The second component of that value is the degree of Federal backing, (e.g., full or partial guarantee) and its effect on lenders and the secondary market. The third component of that value is the financial subsidy which exists to the extent that fees do not completely cover program defaults and administrative costs. As proposed, the Administration credit proposal would in effect tax all three components of that value.

The Administration's FY 1989 budget actually requests appropriations for its own definition of that value, i.e. "grant equivalent subsidies" and indicates that revised credit legislation will be transmitted shortly. The Administration requests an additional $1.3 billion in budget authority in FY 1989 alone for the VA loan guaranty revolving fund to accommodate the credit proposal. That triples the request of $658 million that would be required under current law. Further, the FHA mortgage insurance program request is for an additional $900 million in budget authority despite the fact that the program is self-supporting. Although the GNMA-MBS program does not require appropriations at all because receipts more than cover costs, the Administration budget reflects a request for $1.9 billion in budget authority under the new credit legislation.

MBA believes that identification of these "grant equivalent subsidies" falsely misrepresents the actual dollar costs of these programs and is a theoretical construct which places Federal credit programs on a basis inconsistent with other Federal programs. In no other instance does the Federal budget reflect the economic "displacement" effect of a Federal program, nor does MBA believe it is appropriate to reflect this component. Consequently, budgeting for the estimated economic impact of credit programs, while not doing it for grant or other regular spending programs, penalizes these programs and invites unfair comparisons.

Over the last several decades, the Federal government and the private providers of mortgage funds have developed a working partnership that has successfully facilitated a growth in homeownership and the provision of safe and sanitary housing for many Americans. Through development of innovative financing programs, the Federal government has fostered the flow of capital to housing and mortgage credit. Many of these financing programs are loan, loan guaranty, and insurance programs that--like the VA home loan guaranty program--would be effected by the credit reform proposals. MBA encourages the Committee to evaluate the Administration's proposal carefully before any action is taken, and hold hearings on this proposal. MBA urges the Committee to oppose enactment of the Administration's credit reform proposal.

We would be happy to furnish any additional information needed by the Committee.

Sincerely,

Burton C. Wood

LEGISLATIVE INFORMATION

STATEMENT
OF THE
NATIONAL EDUCATION ASSOCIATION
ON
THE FISCAL YEAR 1989 FEDERAL BUDGET

PRESENTED TO THE
BUDGET COMMITTEE

U.S. SENATE

MARCH 31, 1988

MARY HATWOOD FUTRELL, President • KEITH GEIGER, Vice President • ROXANNE E. BRADSHAW, Secretary-Treasurer
DON CAMERON, Executive Director
(202) 822-7300

Mr. Chairman and Members of the Committee:

The National Education represents 1.9 million education employees throughout the nation in elementary, secondary, vocational, and postsecondary schools. We appreciate this opportunity to comment on an issue of the utmost importance to the future of this nation: the level of federal assistance provided to promote excellence and equity in America's educational institutions.

The United States is at a critical juncture in our history. There is, on the one hand, some uncertainty about the future as we move to respond to the dramatic changes in every facet of American life that have taken place in the latter part of this century. Since the turn of the century, we have seen awe-inspiring technological advances in communication, transportation, health care, and every other scientific endeavor. We have seen, at times, wrenching social changes as minorities, women, the handicapped, and others have fought for and won the right to take part in the opportunities promised in our Constitution. We have seen the world order change and change again as national powers emerge and jockey for world leadership. Throughout that process, America's public schools have been affected by those changes. At the same time they have been required to help our nation's citizens respond to them.

As we look to the future, America's public schools will continue to be an integral part of this process of change. Today's students must be prepared not only to adapt to a changing world, they must also be prepared to initiate changes that will contribute to our nation's future success. It is an awesome responsibility to place in the hands of young people, but Americans have never declined a challenge because it was difficult.

Five years ago, the U.S. Department of Education released a report on the state of education entitled A Nation At Risk. Among its recommendations was a call to "educators, parents, and public officials at all levels to assist in bringing about the educational reform proposed in this report. We also call upon citizens to provide the financial support necessary to accomplish these purposes. Excellence costs. But in the long run mediocrity costs far more." Furthermore, the authors of the report stated "The Federal Government has the primary responsibility to identify the national interest in education. It should also help fund and support efforts to protect and promote that interest. It must provide national leadership to ensure that the Nation's public and private resources are marshaled to address the issues discussed in this report."

The Reagan Administration took this leadership function to mean "do what we say, not what we do.", In every budget year, save FY89, the Adminstration has called for a massive retreat from the federal role in educational excellence and equity. Congress has, for the most part, rejected these draconian cuts. But Congress has not, to date, done enough to fulfill the promise held out by federal education programs.

Without federal Chapter 1 programs, far too many disadvantaged students would receive no assistance to help compensate for a lack of educational opportunities provided by their disadvantaged families. Without federal Handicapped Education programs, far too many mentally and physically disabled persons would be literally turned away from the public schools. Without impact aid, far too many children in areas affected by federal activities would receive substandard educational opportunities merely because of an accident of geography. Without federal bilingual education, far too many students with limited proficiency in English would be forced to sink or swim without language- and skill-building assistance. Without federal Pell Grants, disadvantaged students seeking a better life through an advanced degree would find the college doors shut to them. Every single federal education program plays a key role in enhancing educational excellence, providing educational opportunity, and ensuring that all our citizens have a chance at a better life. And they ensure that all our citizens have an opportunity to make a contribution to our national life.

And yet, despite the important contributions federal education programs have made to the individuals served by them and to our national life, there are still far too many students who are eligible for, but not now served in, federal education programs. Only about 40 percent of the students eligible for Chapter 1 compensatory education services were served in FY87. Only about one-tenth of the students eligible for federal bilingual education programs were served in FY87. Congress provided about one-seventh of the cost of handicapped education programs, far short of the 12 percent provided when P.L.94-142 was enacted and about one-sixth of the 40 percent Congress intended to provide when these programs were created.

NEA is not alone in its call for full funding of federal education programs. The Committee for Economic Development called for a major investment in education:

> An early and sustained intervention in the lives of disadvantaged children both in school and out is our only hope for breaking the cycle of disaffection and despair...Because Chapter 1 remedial reading and mathematics programs and Head Start programs have had demonstrable success in helping narrow the gap in achievement between disadvantaged and non-disadvantaged students, we urge that Federal funding for these programs be brought up to levels sufficient to reach all eligible children.

To carry out that recommendation alone, which NEA endorses, would require an increase of more than $12 billion over FY88 levels.

Moreover, it is not just the NEA, the education community, economists, business leaders, state and local officials, but the American people themselves who demand quality public education for all citizens. A recent Gallup Poll reported that nine out of 10 Americans believe that investing in education is the most essential and effective strategy for ensuring our nation's future security.

Education is the cornerstone of our national life, our best hope for our America's future economic vitality, national security, democratic institutions, and social justice. We urge you to provide adequate resources to protect federal education programs from any cuts, provide adequate inflation increases for all education programs in order to maintain at least the same level of education services provided in FY88, and provide additional resources for needs-based education programs to help restore the level of education services lost over the past seven years because of budget cuts, inflation, and enrollment increases.

Thank you.

THE NON COMMISSIONED OFFICERS ASSOCIATION OF THE UNITED STATES OF AMERICA

"STRENGTH IN UNITY"

Statement of
Richard W. Johnson, Jr.
Director of Legislative Affairs

before the

Committee on the Budget
United States Senate

on the

VA Budget Request
FY 1989

NATIONAL CAPITAL OFFICE
225 N. Washington Street · Alexandria, VA 22314 · Tele: (703) 549-0311

The Veterans Administration budget proposal for Fiscal Year 1989 is viewed by NCOA as generally inadequate to meeting the needs of veterans and the Nation. As it is currently structured, it does not even provide "current services" in some programs. Underlying the inadequacy of the proposal is a major policy failure inherent in the Administration - lack of foresight. The proposal is void of anticipation to meet the needs of veterans in the future. It is a one year budget, unimproved by hindsight, and unencumbered by reality.

It would be impossible to comprehensively discuss every aspect of the proposal. However, listed below are some major program aspects which demand attention.

Burial Benefits

The Regional Cemetery concept must be expanded and augmented by a series of cemeteries proximate to major population centers if this program is to continue to provide reasonable access to burial in a national cemetery to veterans. Regretably the budget proposal does not provide for any expansion of the cemetery system beyond adding 90,000 gravesites at Calverton, New York. This nearsighted policy means fewer than 40 percent of the Nation's veterans will live within a 50 mile radius of reasonable access to a national cemetery. Yet, the Administration proposes to eliminate the burial plot allowance for all but disabled veterans beginning in 1989. This equates to something of a "double-whammy".

As stated in previous testimony, NCOA believes the VA should begin land aquisition and planning to acquire cemeteries in ten major population centers defined in last year's cemetery study not currently served by regional cemeteries. Such aquisitions would make burial space available to nearly 70 percent of the Nation's veterans. NCOA also believes legislation regarding elimination of the burial plot allowance should be rejected, particularly in the absence of reasonable access to a national cemetery.

Instead, the VA should be budgeted and directed on a course to preserve the national cemetery system by providing reasonable expansion in the program.

Compensation and Survivor Benefits

The Administration budget proposal seeks a 4.2 percent cost-of-living increase in disability compensation and survivor benefits effective December 1, 1988. It also asks for legislation to "index" increases in these programs. NCOA fully supports a cost-of-living adjustment in these benefits consistent with measured increases in the Consumer Price Index. However, NCOA is reluctant to support legislation "indexing" or providing for the automatic adjustment of compensation programs.

Currently, the annual congressional review of compensation and survivor benefits prompted by the need for legislation to adjust pay levels assures that the programs will also receive comprehensive review. Congressional willingness to undertake this annual review assures NCOA that disability compensation and survivor benefits will not be allowed to suffer in the absence of legislated automatic increases. Thus, NCOA believes the benefits of annual review outweigh the benefits if indexing.

This year NCOA is hopeful such annual review will lead to the adoption of Representative Mike Bilirakis' bill H.R. 303 providing for the concurrent receipt of nondisability military retired pay and veterans disability compensation. NCOA is also hopeful the committee will review the distribution of benefits in the DIC program with an eye toward compensating all surviving spouses equally. Both of these are issues of equity which should have been addressed years ago.

Education

Unfortunately the budget does not address any necessary or badly needed improvements in VA education programs. While none would be terribly expensive, they have nevertheless been overlooked.

NCOA continues to believe the pay forfeitures required for participation in the Montgomery G.I. Bill should be eliminated. Such charges only serve to discriminate against those who might benefit the most from participation in the program but who by circumstance are financially unable to participate. However, if such fees must be retained, NCOA believes their impact should be reduced by spreading out contributions over a longer period of time and by making the benefits refundable at least to those servicemembers who are unable to use the program because of death or disability. NCOA is also hopeful the benefits of the Montgomery G.I. Bill will be extended to servicemembers who are forced by service personnel policy to retire between July 1, 1985 and June 30, 1988. Through no fault of their own, and despite a willingness to continue to serve, many career servicemembers will lose their opportunity for post-secondary education because they have been caught in a vacuum between the Vietnam Era and Montgomery G.I. Bill.

Additionally, NCOA is compelled to remind the committee that benefits under the Vietnam Era G.I. Bill and the Vocational Rehabilitation Program have not been adjusted since October 1, 1984. At that time, rates were increased by 10 percent over levels set in 1981. Meanwhile, Congress has appropriated billions of dollars in support of non-veteran education programs. NCOA is hopeful these programs will be reviewed this year and that benefits will be increased to restore their value to program participants.

Job Training

Again this year the budget request excludes funding for the Veterans' Job Training Act. However, this program has been responsible for the successful placement of nearly 17,000 veterans in full time skilled employment and has provided some training to more than 33,000 veterans. By comparison with similar efforts the program has been a tremendous success. Accordingly, NCOA believes legislative authority and funding for the program should be extended through FY 1989.

Additionally, NCOA proposes a limited legislative and budgeting authority for a test program of tailored employment benefits. Too often unemployed veterans who are willing and able to work are denied necessary job training or assistance because they fall into a void between program eligibility criteria. As envisioned by NCOA, a discretionary employment and training account could be established to provide veterans employment representatives an opportunity to tailor training needs to individual veterans. If such a program is successful it could sound the death knell for other more limited programs and the burdensome administrative support necessary to their continuation.

Loan Guaranty

Perhaps the most disappointing portion of the budget proposal concerns the VA Home Loan Guaranty Program. Clearly this program is among the most valuable VA programs, not just to veterans, but to the Nation for its trickle down economic benefits. Yet an almost criminally poor policy and management of the program have led it to near ruin. And, the current Administration's obsessive facination with divestiture and privatization threaten to push its recovery out of reach. Furthermore, NCOA believes this responsibility can be laid clearly at the door of the Office of Management and Budget which has continuously directed adverse changes in the loan guaranty program.

This year the Administration has once again proposed negotiated rates for VA loans, the without recourse sale of loans ($780.7 million net in 1989) and a divestiture of $861 million in portfolio assets. NCOA continues to oppose negotiated rates. Such an action would be a gift to mortgage lenders and could increase the exposure of the VA on defaults since guaranty payments are in part based on accumulated interest from time of default. It should also be remembered that fixed VA interest rates are the only benchmark by which both lenders and homebuyers can measure rate competitiveness.

Without recourse loan sales, and, in fact, loan sales in general are a bad idea. The Administration insists on such sales for two reasons. Foremost, there is a desire to produce short term income. Second, the privatization obsession dictates that profit making enterprises should be sold to private industry.

Such logic is misguided at best.

Such sales and divestiture from a government perspective mean only the sale of self-sufficiency in the program. The VA recently announced it had sold $219.3 million in loans for $220.5 million. The margin by measure was .54 percent above par. The monthly income from those loans averaged .79 percent. In other words the VA sold a thirty-year monthly income of more than $1.5 million for a one time profit of $1.2 million. Such a sale might make some modicum of sense in private industry if the profit were rolled into an income producing investment, but it hardly makes sense to government. Such sales and divestiture from a government perspective mean only the sale of self-sufficiency in the program.

NCOA urges the reconstruction of the VA Home Loan Guaranty Program. Rebuilding the portfolio can eliminate the need for fees charged to veterans, can mitigate the worries of holding a large foreclosure inventory and can eliminate the need to steal profit from the unfortunate veterans through such devices as "net value" equations in foreclosures. (The net value equation allows the VA to keep 10.75 percent of the value of any home at foreclosure plus any other costs owed by the veteran even though veterans pay a funding fee to protect against these costs.) It will take several years to accomplish, and it will take substantial budget authority and appropriations, but it took several years to create the problem. The loan guaranty program cannot be repaired overnight, but a sure, permanent and perpetual fix is available. With patience and appropriations the assets of the fund can be increased to a level at which income will once again exceed outlays.

Insurance Programs

NCOA recommends that amounts of insurance available through SGLI and VGLI programs be reviewed and increased to more adequately meet the needs of veterans. It has been two years since the current maximum coverage amounts were established. Yet these rates have already been overcome by inflation.

Additionally, NCOA is pleased to recommend that military retirees subject to recall be allowed to retain VGLI on the same renewable term basis and for the same reasons as members of National Guard and Reserve components. Military retirees are a valuable national security asset. Since VGLI benefits are fully premium supported this is an excellent opportunity to provide a no-cost benefit to deployable retirees.

Medical Care and Construction

It would be difficult to convey in a reasonable period of time all the disagreements NCOA has with the medical care and medical construction proposal.

The VA should have begun a program of building the medical care system several years ago. Instead, it chose a course of maintenance. Now, the system is at best marginally equipped to meet the needs of veterans and, by projection, will not be able to keep up with the increasing demand for service, particularly from an aging veteran population.

The system must prepare to meet the geriatric care need of more than 7 million veterans who will be 65 years of age or older in 1990. That's more than twice the number of veterans over 65 in 1980. Nursing care demand can reasonably be expected to increase by 3,500 beds in the next four years yet the budget proposes the construction of only one 120 bed new nursing home.

The system also now faces the additional stress of providing AIDS treatment and research which is consuming even larger portions of the budget. Yet, rather than seek altogether new funding to meet this new demand, the budget proposes to rob part of these costs from other care and research programs.

Altogether, medical care is down $370 million from a current services level. This is hardly a competent proposal to meet the medical care needs of veterans.

Consistent throughout the medical care and construction budget is a lack of planning for future needs. The budget also totally ignores the national emergency role of VA medical facilities. NCOA urges the committee to increase medical care spending to at least a current services level or, more desirably, to a level which allows real growth in the program.

Staffing

As always, the budget proposes staffing reductions to achieve budgetary savings. Notwithstanding increasing medical care demands the budget proposes to eliminate 1,782 medical personnel. Even with complaints about delays in claims adjudication the budget proposes to cut 248 claims processors. And, in spite of the obvious problems in the home loan guaranty program, the Administration wants to cut 75 loan guaranty employees.

Unfortunately, there are no good guidelines on staffing at the VA. Yet it is obvious that such personnel cuts will adversely impact on services in both timeliness and availability. In view of the growing demand for VA services, NCOA must oppose staffing cuts.

Conclusion

As previously stated, NCOA believes the VA budget proposal is inadequate to meeting veterans needs. The most seriously deficient areas of the proposal are in the medical care and loan guaranty programs. However, there is a general deficiency in policy evidenced throughout the document. It does not plan for the future.

Furthermore, NCOA believes much of this proposal is the product of OMB budget cutting decisions that would have been made differently if they had been presented to the President by a member of his Cabinet. Almost as if planned, this budget provides an eloquent argument to have policy decisions regarding the VA elevated to Cabinet status. NCOA is hopeful that Congress will move quickly to establish a Department of Veterans' Affairs in hopes of preventing the submission of such an inadequate budget proposal next year.

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VIEWS OF THE REAGAN ADMINISTRATION

FRIDAY, MARCH 4, 1988

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:36 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Sasser, Lautenberg, Wirth, Conrad, Domenici, Symms, Grassley, and Nickles.

Staff present: Richard N. Brandon, staff director; and John Hilley, assistant director for macro-economics, trade and finance.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Good morning, Mr. Secretary, and welcome to the Senate Budget Committee.

Most of us on this committee recognize the good work you have done at Treasury during some very difficult times. You certainly were a key player during last year's economic summit, and you have been an activist in the difficult world of international finance.

Everybody knows we are having competition problems. In fact, about 2 weeks ago, there was a small item in the newspapers about the sale of a Georgia company to West Germany. The name of the Georgia company was Astroturf. They make and install playing fields in stadiums around the country, including Texas Stadium, where the Dallas Cowboys play.

So, if we think about that, we are going to have American teams playing on German turf, which might just be one of the examples of how we are losing some of our footing in foreign competition.

I know you are just back from Korea, and the world needs more open markets, and the United States has to keep the pressure on to make sure that happens, especially among countries with surging economies like Korea. In just 3 years' time, there has been an $11 billion swing in our trade accounts for the Koreans, from a $1 billion American surplus to a $10 billion deficit.

I think you took them the right message about open markets. Hopefully, it will pay of, but now, of course, I think we have to keep an eye on the bottom line and make sure we follow through.

We have got other trade problems, too. Many of our former export markets in Latin America have dried up, and those Latin American economies are still very much in debt. I think you deserve high marks for your low-profile but effective work on the Mexican swap.

This voluntary market-based approach lets banks swap old debt for new and helps Mexico by reducing its debt burden. Although the results of yesterday's first auction were a little disappointing, I hope we can encourage more movement in that direction.

It may not be the ideal solution, but it is a practical way of dealing head-on with a major problem.

Of course, world debt and our trade deficits are not our only problems. The number one economic problem at home, obviously, is the Federal deficit. Chairman Greenspan of the Federal Reserve told us on Tuesday what should be obvious to everyone, that we need to get the unified budget into surplus; we need to get the national operating budget under control so that social security can become a source of true national saving and investment as we work toward a higher standard of living.

With the deficit such an enormous problem, I confess I was a little puzzled by events earlier this week. Chairman Greenspan told the Budget Committee we have to be candid, realistic, and willing to explore other revenue sources. He even talked about a gasoline tax. Then, I went to Appropriations and heard you say, Mr. Secretary, that the deficit must come down by concentrating exclusively on the spending side, and one of the reasons we should go that route is it is easier for Congress to raise taxes than to cut spending.

In this decade, we have not raised taxes. Obviously, we have cut taxes from over 20 percent of GNP to around 19 percent, and we have cut spending, too, dramatically. Domestic discretionary spending has fallen from about 6 percent to an historic low of 3.7. We would like to hear more about your differences with the Chairman of the Federal Reserve during the course of our hearing today. And all of us would welcome your thoughts about a by-product of the discipline we have imposed on the budget-cutting effort, and that, of course, is the tendency of our new Federal programs to be put off-budget rather than to be in plain view.

It just seems to me we have got to be careful not to sign onto a lot of open-ended obligations whose magnitude is camouflaged.

Secretary Baker, I want to repeat the observation that you have been doing a first-rate job. We all know it is not going to get any easier. I hope we can look at our problems clearly today and without any illusions. We certainly look forward to your testimony.

Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Thank you very much, Mr. Chairman.

Secretary Baker, I too want to join in complimenting you on the marvelous job that you have done. On the short-term horizon, obviously, it is my own personal opinion that we could not have completed the summit without your presence on behalf of the President. While many are not thoroughly pleased with that effort, if we can enforce that agreement this year, I think we will have done a pretty good two-year effort in behalf of deficit reduction. So I thank you for your work there.

I am not going to take any other time in this opening statement. I am going to have to leave early. But I do want to suggest to you, Mr. Secretary, that I understand there is pretty good economic news out this morning with reference to unemployment. I understand it is down again and that a substantial number of new jobs have been added to the American economy since the unemployment rate was last reported.

But I still remain unconvinced that interest rates are where they ought to be. I believe they are still too high. I cannot understand why they remain at unusually high real rates, and I cannot understand why they are substantially no lower than they were 2 years ago in real terms.

I hope you will answer that. If you don't in your opening remarks, that will be the thrust of my questions this morning.

Thank you, Mr. Chairman.

Chairman **Chiles**. Thank you, sir.

Mr. Secretary.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY OF THE TREASURY

Secretary **Baker**. Thank you, Mr. Chairman.

Before I summarize my written statement, may I respond to a couple of points that you made in your opening remarks.

It seems to me that in the example you gave about German investment in the United States, American teams are playing on Astroturf, Astroturf that was made in America, by Americans, for Americans, utilizing German investment capital. That is good for America.

Chairman **Chiles**. Where would the profits go?

Secretary **Baker**. Some of the profits would go to some of the owners. But it creates jobs here, it creates technology. Open investment, Mr. Chairman, is one of the reasons, if not the foremost reason, why the American economy has been the foremost economy in the world for a long, long time. We really ought to consider this very, very carefully before we start talking about restricting foreign investment in the United States.

I just wanted to make the point——

Chairman **Chiles**. I hope you didn't get anything in my remarks about restricting. I am just saying I think it is too bad that we have to see these American companies changing ownership and changing hands.

Firestone has always been a name that had a lot of significance to me, I guess from being a kid, I used to play around the Firestone store and everything else. To think that it is no longer in American ownership disturbs me.

Secretary **Baker**. Well, for the first 150 years or so of our existence, we were on the receiving end of foreign investment.

Chairman **Chiles**. I don't remember any of that.

Secretary **Baker**. I think that was very good. You may not remember it; I certainly don't remember it, either, but it was a good thing for the United States.

People say that the United States is a net debtor nation now, a bigger debtor nation than Mexico, Brazil or Argentina. We ought to keep that in proper perspective, however. We ought to take a look at that debt as a percentage of GNP, and in our case it is a relatively small fraction.

The only point I want to make is I hope you are not suggesting that we ought to somehow restrict or screen or deny foreign investment.

Chairman CHILES. My restriction would be to stop the borrowing, having to borrow; then we would not have that. That would be my restriction, to get us so we do not have to borrow.

Secretary BAKER. I think if we could reduce the trade deficit, that would be the proper solution to the problem you are pointing out, and I quite agree with you on that, and that is something that we have been moving on over the course of the past couple of years, and I think with some reasonable degree of success. We can pursue that a little bit later on.

You said that I said before the Appropriations Committee that it is easier to raise taxes than it is to cut spending. I think you and I and the ranking member there all remember what faced us in the budget summit where we sat around the table there for 4 weeks. There was never any difficulty in determining that we could, if we needed to, raise some revenues. What we had trouble with for 4 weeks was finding someplace to cut spending.

You said that we have not raised taxes over the last 7 years, even though I said it was easier for Congress to raise taxes than to cut spending. We haven't raised taxes because we have had a President who has made it his number one priority to cut taxes and to reduce the tax burden on the American people. And he has been firm, and he has been resolute in that regard, and that is why we haven't raised taxes over the past 7 years, not because it is not easier to do than cutting spending.

But Mr. Chairman, I would appreciate it if I might give you a brief summary of my written statement and ask that the written statement be inserted in the record.

Chairman CHILES. The statement will be inserted in the record.[1]

Senator DOMENICI. Mr. Chairman, might I just make this observation?

I appreciate your answer to my friend, Senator Chiles', description of the foreign acquisition, and I agree with you that one of the strengths of the free industrial nations combined is the pool of money.

I am firmly convinced that the negative that is attributable to our deficit has to do with the future and growth, not the past. We have been doing pretty well. I think the big issue in terms of available money to be invested and borrowed is interest rates. If interest rates are too high, then obviously, it is a tremendous drag on the future.

I am advised, Mr. Secretary, that a huge new pool of money from the Japanese money markets—$2 trillion in Maruyu bonds—are going to be taxable in Japan shortly, and they have not been nontaxable before. That is more savings than we find in any single place. Some of that is going to find its way to the American economy now; because it was tax exempt before, it is going to become taxable.

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[1] See p. 175.

Those are the kinds of things that I think are important in terms of interest rates. If interest rates don't come down when there is plenty of capital around, and when crowding out is no longer an issue because we can use foreign capital, I keep wondering if they'll ever come down. That may be the one big negative with reference to foreign capital. I am not sure of that, but it may be, if interest rates have to be extraordinarily high to attract it.

Secretary **Baker**. Well, some of that capital might flow into the United States. I think that is inherently good. Some of the change in the Japanese tax code, however, should be reflected in increased domestic demand in Japan, which is something that we have been encouraging for a long time. We have encouraged the Japanese to take a look at the possibility of taxing savings, because they have had this tremendously high savings rate that was limiting their domestic demand and was contributing to and exacerbating the external imbalances that exist around the world.

Senator **Domenici**. Thank you.

Chairman **Chiles**. Mr. Secretary, I will let you make your statement, but I wanted to make one more observation about your remarks about the earlier history of our country and the capital coming in.

That was very necessary at the time, and it helped. My understanding of history is we were using that capital as we tried to build the base of this country—our infrastructure, what industry we could build at that time.

I am afraid that much of the foreign capital that is coming in now, we are using to further our consumption——

Secretary **Baker**. That is true, Senator. Some of it we are using, frankly, to service debt, and that is not good.

Chairman **Chiles**. That is right.

Secretary **Baker**. The point I want to make is——

Chairman **Chiles**. If we were rebuilding the capital base with that, it would make a lot of sense. But if we are using it to spend or to pay for debt, it doesn't make a lot of sense.

Secretary **Baker**. To the extent that foreign capital inflows create jobs, create output and create technology, they are good. To the extent that they flow into service debt, they are not. This is why we have to reduce the trade deficit. I think we agree that this has to be done, and we are working toward that end in a bipartisan way in this country.

Let me just make one or two brief comments, and I will dispense even with reading the summary of my statement.

I would like to make the point for the record, Mr. Chairman, that the U.S. economy exceeded almost all expectations in 1987. It exceeded those expectations notwithstanding many prognostications of doom, gloom, and collapse. It is our view that prospects for continued expansion this year are encouraging.

Senator Domenici has mentioned already that there was a decline in the unemployment rate in the data released this morning. These data also revealed a significant increase in the numbers of jobs. This is all very encouraging.

We are in the 64th successive month of our current expansion, the longest peacetime expansion on record. Last year, we projected real GNP growth in the neighborhood of 3.2 percent over the four quarters. The consensus of private economists projected it to be a little less than 3 percent. Real growth was actually 3.9 percent, exceeding not only our projection but those of the private sector forecasters as well.

During 1987, the civilian unemployment rate dropped by nearly one full percentage point, from 6.7 to 5.8 in December of 1987, and as I just noted, it fell another one-tenth percentage point this morning to 5.7—the lowest unemployment rate of this decade.

Employment rose by about 3 million people in 1987, bringing the total to more than 14.5 million new jobs since the end of the recession in November 1982. Mr. Chairman, that is more new jobs than Western Europe and Japan have created in the last two decades. Today, the percentage of the working age population that is employed in the United States is at an all-time high.

Last year's inflation rates were higher than they had been in 1986, but that reflected the 1986 drop and subsequent rise in oil prices. The inflation rate has averaged under 4 percent over the course of this 64-month expansion. This is a rather remarkable achievement when you recall the situation that existed in this country in 1980, when inflation was economic enemy number one. Many assumed that inflation was here to stay. I remember the political debate in 1980; many people felt that the best thing to do was to hedge against inflation, because inflation was going to remain with us.

I would also like to comment on our progress in the manufacturing area, which was particularly striking last year. In 1987, industrial production rose by almost 5.4 percent, following an increase of only a little more than 1 percent during 1986. Employment in manufacturing rose by 407,000 during 1987, following declines in each of the 2 previous years.

Much of this rebound in manufacturing reflects a revival of America's exports as a more reasonably valued dollar lets the competitiveness of U.S. producers and U.S. exporters shine through.

In volume terms, the U.S. merchandise exports in the four quarters of 1987 rose almost twice as fast as any other yearly increase in this expansion. Mr. Chairman, you were quite right in noting that we must reduce the trade deficit if we are to decrease net capital flows into this country.

But by almost any criteria 1987 and the 4 years preceding it were a sound economic performance, one that should serve as a solid foundation for continued growth in the coming year.

Our forecast for 1988 reflects divergent forces that have emerged. On the one side, industrial production remains relatively robust. On the other side, consumer demand appears to be slowing. Consequently, we expect real growth to moderate, particularly over the first two quarters of this year, although the employment data released this morning are extremely encouraging.

On balance, inflation in 1988 should be little changed from what it was in 1987. We expect real GNP to rebound from a 2.4-percent growth rate in 1988 to 3.5 percent across the four quarters of 1989.

Mr. Chairman, it is our considered judgment that if sound economic policies are pursued, including a steady and moderate growth of the monetary aggregates and continued reduction in the budget deficit through restraint in spending as opposed to increasing taxes, we see no reason for the turmoil in the financial markets of last fall to lead us into an economic downturn.

We think that an important impetus to growth this year will come from further improvement in the trade balance. It is our view that the United States is making the adjustment from an expansion driven primarily by domestic consumption to one driven primarily by exports. The impact of the decline in the dollar, accompanied by policies designed to stimulate growth abroad, has led to a shift in the composition of our GNP in that way. Since the third quarter of 1986 when the merchandise trade deficit in volume terms was at its widest, improvement in the real merchandise trade balance has accounted for fully one-fifth of the growth of real GNP in the United States.

The agreements which we have made with the other major industrial countries—the Louvre Agreement, the agreement of the G-7 in April in Washington, and last December's Group of 7 statement—paved the way for continued resolution of these external imbalances and therefore additional growth for the United States.

Deficit spending in the United States is being curtailed. You are aware of the $70-plus billion reduction in the deficit that occurred in fiscal 1987. You were a party to and largely responsible for, along with the ranking member, the agreement between the executive branch and legislative branch, which should reduce the deficit by $76 billion in 1988 and 1989. So we are making strides to reduce our deficit. If the President's budget is enacted, our deficit in 1989 will be 2.6 percent of GNP, which is a very, very reasonable figure.

Japan is pursuing economic policies, in addition to the one I mentioned just a few minutes ago, to sustain strong domestic growth, and their domestic demand has risen significantly. Germany has taken measures to improve growth, including advancing some tax cuts and providing additional investment incentives. Furthermore, monetary policy in Germany and some of the other countries of Western Europe has, we think, moved in the right direction since last fall.

With the world economy just starting to benefit from these efforts at international cooperation and coordination, it is our strongly held view, Mr. Chairman, that we couldn't pick a worse time to resort to protectionism in the United States. We will soon be debating the omnibus trade bill, and it is our hope that the legislative and executive branches, working together, can construct a good trade bill that is not protectionist. That is the objective of the administration, one that we have been pursuing and will continue to pursue. But, nothing would more surely close foreign markets and create unnecessary uncertainty than legislation which is protectionist in closing markets here in the United States.

Mr. Chairman, I would like to draw your attention to the three charts that are attached to the statement which show the decline of Federal debt as a percent of GNP and the decline of interest payments as a portion of the budget.[1]

I should perhaps say a couple of things on the budget process itself and on tax reform. On tax proposals generally, let me simply say that this budget does not contain any major new tax proposals. In light of the landmark changes which were brought about by the Tax Reform Act of 1986, it is the view of the administration that it is absolutely imperative that we give taxpayers, businesses, investors and in fact even government a chance to breathe, a chance to absorb this very comprehensive overhaul of the Tax Code. Thus, we really ought to refrain from proposing any major changes in the Tax Code.

While we are succeeding in reducing our budget deficit along the lines that I mentioned, it is our view that the budget process itself has fallen into considerable disarray. For 2 consecutive years, as you know, the Congress has delivered a mammoth omnibus appropriations bill well into the fiscal year that the President either has to sign in a matter of hours, or shut down the government. It is our view, Mr. Chairman, that the budget process itself should be reformed, root and branch.

In conclusion, we enter 1988 with cautious optimism. The economy continues to exhibit considerable forward momentum, as evidenced certainly by the unemployment data released this morning. The continued restraint of government spending in the President's fiscal year 1989 budget is an extension of the policies that have promoted strong, sustainable and noninflationary economic growth over the last 64 months.

Mr. Chairman, I am sure that by working together, the administration and the Congress can provide a budget that consolidates some very hard-fought gains on deficit reduction without sacrificing funding for the necessary and important functions of government.

Thank you, Mr. Chairman.

Chairman CHILES. Thank you, Mr. Secretary.

[The prepared statement of Secretary Baker follows:]

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[1] See pp. 193–195.

Testimony of the Honorable James A. Baker, III
Secretary of the Treasury
Before the
Senate Budget Committee
March 4, 1988

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today to discuss the economic outlook and the Administration's budget.

1987 in Review

The pace of U.S. economic growth improved in 1987, exceeding almost all expectations. Prospects for continued expansion this year are encouraging despite the stock market decline. Exports are growing strongly and the improving real trade balance continues to add to domestic output growth. We have made considerable progress on the Federal budget deficit. Last year's budget summit and ensuing legislation were positive steps toward ensuring that this progress will continue.

The current expansion is now in its 64th month and is the longest peacetime U.S. expansion on record. Income and employment have risen impressively while inflation has been held to a moderate pace.

While our focus today should be on the present and the future, it is worthwhile to review last year's experience. At the beginning of last year, some forecasters doubted that a strong expansion would continue. The Administration was criticized by some for issuing an overly optimistic forecast. We projected 3.2 percent real growth over the four quarters of 1987. The consensus of private economists projected a little less than 3 percent growth and a few economists were warning of recession. As it turned out, real growth was 3.9 percent, exceeding our own projection as well as the consensus of private sector forecasters.

Continued expansion of the economy last year led to lower unemployment rates and a high rate of job creation.

- During 1987, the civilian unemployment rate dropped by nearly one full percentage point from 6.7 percent in December 1986 to 5.8 percent in December 1987, the lowest rate of this decade. The unemployment rate for blacks was down by 1-1/2 percentage points and that for Hispanics by more than 2 percentage points.
- Employment rose by about 3 million persons in 1987, bringing the gain across the entire expansion to more than 14-1/2 million. This is more jobs than Western Europe and Japan have created in the last two decades. By the end of last year, the U.S. employment ratio (those working as a proportion of the working-age population) was at an all-time high.

Last year's inflation rates were higher than they had been in 1986 but this reflected the 1986 drop and subsequent rise in oil prices. The U.S. inflation rate has averaged less than 4 percent over the expansion--a remarkable achievement. In the past, the rate of inflation has typically risen as an expansion has proceeded, necessitating more restrictive policy which could endanger continued economic growth. But such inflationary pressures have not appeared in the current expansion.

Our progress in the manufacturing area has been particularly striking. The resurgence of U.S. manufacturing was an important feature of last year's economic developments.

- Industrial production rose by 5.4 percent over the twelve months of 1987, following an increase of only a little more than 1 percent during 1986.
- Employment in manufacturing rose by 407,000 during 1987, following declines in each of the previous two years.
- In 1986, the last year for which full international data are available, the United States was the only one of twelve major industrialized countries to register a decline in unit labor costs in manufacturing.
- Much of the rebound in manufacturing reflects a revival of America's exports as a more reasonably valued dollar lets the competitiveness of U.S. producers shine through. In volume terms, U.S. merchandise exports in the four quarters of 1987 rose almost twice as fast as any other yearly increase in this expansion.

By almost any criteria this has been a sound economic performance, one that should serve as a solid foundation for continued growth in the coming year. Hurdles remain, but they can be overcome with appropriate and timely policy choices.

In the fiscal area, we made welcome progress in reducing the Federal budget deficit. In the 1987 fiscal year concluded last September, the deficit fell by $71 billion--the largest single-year decline on record. While special factors accounted for some of the decline, the key ingredients were spending restraint and robust economic growth. Remarkably, Federal outlays actually fell in real terms for the first time in 14 years.

The budget agreement between the President and the joint leadership of Congress reached late last year is a significant step toward assuring continued fiscal restraint. We believe that we have shown the public and the financial community that the Administration and Congress are able to work together to get control of the Federal deficit.

On the monetary front, 1987 was a year of adjustment by the Federal Reserve. As 1987 began, it was clear that the pace of expansion in the monetary and reserve measures in late 1986 had been excessive and that inflationary expectations were being rekindled. Thus, some deceleration of monetary growth was desirable. The Fed, however, responded immediately to the stock market crash in October in a successful, and widely praised, effort to provide needed liquidity to the financial system. By the end of the year, interest rates were down from their October highs, but moderately higher than they had been at the beginning of the year.

Economic Forecast for 1988 and Beyond

The Administration forecast for 1988 reflects the divergent forces that had emerged by the end of 1987. On the one side, production remains robust as the industrial sectors demonstrate substantial forward momentum. On the other side, domestic demand appears to be slowing as consumers respond to the dramatic decline in stock prices last fall and the lagged effects of a more cautious monetary policy during last spring and summer. Consequently, we expect real growth to moderate from the 3.9 percent across the four quarters of 1987 to 2.4 percent during 1988.

On balance, inflation in 1988 should be little changed from 1987. We project consumer prices to increase in 1988 by a little less than in 1987.

Following relatively moderate real GNP growth this year, we expect a rebound to a growth rate of 3-1/2 percent across the four quarters of 1989. For the years thereafter, we have projected that the economy will gradually move to a position of relatively full utilization of resources. Of course, it is impossible to forecast the exact path of activity over the longer term, and we recognize that actual movements of the economy will be far more cyclical than the smooth path in these working assumptions.

The Administration forecast of real growth this year is well within the range of private forecasts. It is just slightly ahead of the Blue Chip consensus of about 1.8 percent, fourth quarter to fourth quarter, which is also the figure projected by the Congressional Budget Office. As already noted, our forecast for 1987 came closer to the mark than either the private consensus or CBO. The Administration forecast has underpredicted real growth in three of the last five years of economic expansion.

Admittedly, there are a number of uncertainties in the outlook for this year. When we first began preparation of the forecast for the FY 1989 budget, the decline in the stock market had only recently occurred. Many private analysts were predicting that its impact on household balance sheets and hence on consumer spending would be so severe that the economy would be tipped into recession. Other analysts were more impressed by the considerable forward momentum of the economy and were concerned that it would proceed at such a pace as to reignite inflationary pressures.

Subsequent events appear to have confirmed that the middle course chosen for the Administration forecast was the correct one.

- Clearly, the forward momentum of last fall has been tempered. Consumer spending slowed somewhat toward the end of 1987, perhaps partly in response to the stock market decline, though the pattern of consumer spending had softened somewhat earlier in the year. Inventory imbalances have emerged in scattered segments of the economy, most notably at retail trade.

- On the other hand, the pace of new order placement with manufacturers and the mounting backlog of unfilled orders confirm that there remains substantial forward momentum in the industrial sector.

- Moderation of consumption, higher saving and rising orders have coincided with a shift in activity toward export-led growth and a larger role for business fixed investment.

It is our judgment that if sound economic policies are pursued -- including steady, moderate growth of the monetary aggregates and continued reduction in the budget deficit through restraint of spending -- there is no reason for the turmoil in financial markets of last fall to lead to an economic downturn. Nor would there be reason for the forward thrust of the industrial sector to get out of hand and generate the types of excesses that eventually resulted in downturns in the past.

An important impetus to growth this year should come from further improvement in our trade balance. The impact of the decline in the dollar in foreign exchange markets, accompanied by policies designed to stimulate growth abroad, has led to a shift in the composition of U.S. GNP growth toward rising exports and substitution of domestic production for imports. Since the third quarter of 1986, when the dollar merchandise trade deficit in volume terms was at its widest, improvement in the real merchandise trade balance has accounted for fully one-fifth of the growth of real GNP, as the real volume of our merchandise exports rose at an annual rate of 19 percent while imports increased at a rate of only 4 percent. The latter represents a marked slowing from the 14 percent annual rate of growth averaged across the three previous years.

- The dramatic improvements in the tradable goods sector of our economy are illustrated by the increase in production of steel by U.S. mills of one-third in the fourth quarter of last year from a year earlier. This, along with a rationalization of productive capacity, has propelled the capacity utilization rate in the steel industry to 95 percent, the highest since 1978.

- To cite another example, the value of shipments in the semiconductor industry jumped 13 percent last year measured in nominal terms and by more than that if correction is made for declining prices in the industry. The trade gap in semiconductors has been cut by more than one-half from the $2-1/4 billion deficit in 1984.

Overall, rising production has pushed up operating rates to some of the highest levels witnessed since the 1960s in such industries as paper and textiles. These high capacity utilization rates, along with a dramatic improvement in profits in the industrial sector, imply continued strength in business capital spending, another element pointing to sustained economic expansion during 1988.

An additional positive influence this year is the full implementation of the Tax Reform Act of 1986. Though impossible to isolate, some economic activity may well have been postponed until this year when tax rate reduction became fully effective. Spendable incomes of consumers were boosted at the start of 1988 by the reduction of 6 or 7 percent in withholding, though a portion of that is being offset by higher social security tax rates.

The International Economy

With the U.S. economy turning to export-led growth, developments abroad play an important role in our 1988 outlook. Last year real GNP in the industrial countries grew nearly 3 percent -- the fifth year of sustained expansion from the 1982 recession. We expect another year of 2-1/2 to 3 percent real growth in 1988. Inflation in the OECD countries in the last two years has reached the lowest rates since 1967, and should remain low.

We are also beginning to see progress in reducing external imbalances worldwide, even though more needs to be achieved. Patterns of demand are changing. Last year demand from domestic sources in the United States moderated, while foreign demand for our exports grew sharply. In 1987 real net exports of goods and services added to domestic output growth for the first time since 1982. With domestic demand abroad likely to remain considerably stronger than in the United States, the real trade balance should continue to improve. Furthermore, this substantial strengthening in our real trade balance should also be reflected by lower nominal trade and current account deficits this year.

Over the past years, the major industrial countries have intensified efforts to strengthen international economic policy coordination. The key focus of these efforts has been to achieve reductions in external imbalances in the context of sustainable noninflationary growth and greater exchange market stability. We have made substantial progress in achieving these goals.

At the Tokyo and Venice Summits, the Heads of State or Government of the Economic Summit countries developed and refined a new coordination process, using economic indicators, to assess the consistency and mutual compatibility of policies and to determine if a significant deviation from an intended course was emerging, requiring remedial action. The major countries have also agreed on the basic directions that their policies should follow and--as evidenced at the Louvre last February, in Washington last April, and in last December's Group of Seven statement--have made specific commitments to achieve these ends. U.S. deficit spending is being curtailed. Japan is pursuing economic policies to sustain strong domestic growth, including monetary policies to accommodate declining interest rates. Germany has taken measures to improve growth, including advancing tax cuts, providing additional incentives to investment and reducing short-term interest rates.

The substantial changes in currency values that have occurred are contributing importantly to the reduction of external imbalances. The major industrial nations have agreed, however, that a further decline in the exchange rate of the dollar could be counterproductive. Therefore, the United States has and will continue to work closely with its major trading partners to foster exchange rate stability and I want to assure you that the U.S. will do its part in this effort.

Despite the substantial progress that has been made, there is clearly room for further improvement. We need to make coordination a more effective process for encouraging the sound policies necessary for improved global growth and financial stability. One potentially helpful measure, which I proposed in my speech to the Annual Meetings of the World Bank and IMF, is the use of a commodity price index including gold, as one indicator, among others, of global inflationary and deflationary trends.

In the area of trade policy, the Administration has gone to unprecedented lengths to open up foreign markets, although these measures, of course, can only reinforce our macroeconomic efforts to moderate our international imbalances. We have negotiated a comprehensive bilateral arrangement with enormous potential economic significance, the Free Trade Agreement with Canada. I would like to elaborate briefly on this because of the unprecedented opportunities it presents. Under it, both countries will eliminate tariffs with their largest trading partner, protect rights of investors, enhance energy security, establish a framework for services, and remove many irritants. We have also negotiated a framework agreement with Mexico to address trade and investment issues.

It was largely as a result of our initiative and persistence that the Uruguay Round was launched. We are now through the first stage, that of identifying issues, and are moving into substantive negotiations. We hope, through a mid-term review, to have some preliminary results this fall, particularly in the very important area of agriculture. Bilaterally, we continued to maintain strong measures against unfair foreign trade practices, taking on issues like Japanese cigarette restrictions, Korean insurance, EC subsidies on canned fruit, and Taiwan's restrictions on alcohol.

In view of the recent rapid expansion in U.S. exports, it is particularly important to maintain the momentum in our market opening efforts. Protectionist legislation is always bad. But this would be perhaps the worst of times. Our exporters and their employees are starting to benefit enormously, some from several hard years of cost-cutting and reorientation as well as from international developments. Nothing would more surely close foreign markets and create unnecessary uncertainty than legislation that closes our markets. We should work together to avoid that.

A sound world economy also requires further progress in dealing with the debt problems of the developing countries. The United States will continue to play an active role in coordinating international efforts to address those problems. The success of the present strategy depends critically upon debtor countries' efforts to improve growth in their own economies. Support for market-oriented reforms through new financial flows from international financial institutions and commercial banks is also essential.

Considerable progress has been made under this strategy during the past two years. To help sustain these efforts and ensure adequate international support, we have supported negotiations on a global capital increase for the World Bank. We have also proposed the creation of a new IMF External Contingency Facility to help cushion the effect on IMF standby programs of unforeseen external developments, such as weaker commodity prices or sustained higher interest rates. And, we have encouraged the development of a "menu" of alternative financing options.

In contrast, so-called "comprehensive" or "global" solutions involving transfer of the problem to taxpayers in creditor countries are unacceptable. In addition to the major cost to taxpayers, these proposals are even counterproductive to long-term growth because they would discourage new private money flows in the future, fail to secure market-oriented adjustments in debtor nations, irreparably politicize the problem by consolidating it in a centralized forum and encourage debt repudiation.

Budget and Deficit Overview

We made substantial budget progress in FY 1987. The final statistics show a $150 billion deficit (3.4 percent of GNP) in FY 1987, down $71 billion from the $221 billion (5.3 percent of GNP) in FY 1986. Relative to GNP, the 1.9 percentage point reduction in a single year is a major accomplishment. Even though we benefited somewhat from higher than expected revenues from the Tax Reform Act of 1986, the keys to our success were, and must continue to be, spending restraint and sustained economic growth. After adjusting for inflation, Federal outlays actually fell in FY 1987, the first such decline in 14 years.

Looking forward, we made even further progress as a result of the 1987 Budget Summit and the associated legislation. This is reflected in the substantial improvement in the current services estimates. Under current services projections, the deficit is projected to fall significantly in the coming years. Earlier in the decade, in the wake of the 1980 and 1981-82 recessions, Federal debt was rising as a share of GNP, and debt service was rising as a share of the budget. Today, we project under current services that Federal debt held by the public as a share of GNP will be flat in FY 1988 and FY 1989, and fall thereafter. Net interest will be falling as a share of GNP in FY 1989 and will be declining absolutely by FY 1992. Still, there is work to be done.

Congressional adoption of the President's budget proposals to implement the remainder of the budget summit agreement would continue to move the Federal Government along the path of needed expenditure control, and reduce the deficit even faster. Because of the progress that has been made to date, the policy changes in the President's budget relating to deficit reduction are not as large as in previous budget submissions, and should be readily achievable by the Congress. The proposed budget would reduce the deficit from $147 billion in FY 1988 to $130 billion in FY 1989 (from 3.1 percent of GNP to 2.6 percent)--a clear message to the American people and to financial markets that deficit reduction is firmly in place -- and to $23 billion in FY 1993 (0.4 percent of GNP).

Two important turning points are projected in the FY 1989 budget. These turning points reinforce the message to financial markets that the deficit is under control. As the first attached chart demonstrates, interest payments on Federal government debt as a share of the budget are projected to decline after FY 1988. No longer will growing interest payments force contraction in other parts of the budget. As the second attached chart shows, the economy is growing faster than the national debt. By FY 1992 the debt will be rising less rapidly than the rate of inflation, and will actually be falling in real terms.

Federal receipts will be growing strongly in absolute terms as the economy itself grows, and as previously scheduled increases in payroll taxes become effective this year and in 1990. Receipts are projected to rise by an average of almost 8 percent annually between FY 1987 and FY 1993, just under the 9 percent rise averaged in the previous seven-year period. Receipts are expected to remain at a relatively constant share of GNP, over the next six years, between 19.2 and 19.5 percent.

The American people are not undertaxed; the Government has overspent. As shown by the third chart attached to my statement, Federal revenues as a share of GNP have generally exceeded their 1964-1979 average during the past seven years and are projected over the next six years to average one full percentage point above this historical norm. In contrast, the Federal budget's outlay share of the GNP has, on average, exceeded the 1964-79 average by 3.5 percentage points during the past seven years. Continued spending restraint, as proposed in the FY 1989 budget, should shrink the share of GNP spent by the Federal government to 19.8 percent in 1993, the lowest it has been since the late 1960s.

This budget does not contain any major new tax proposals. In light of the landmark changes in our tax structure brought about by the Tax Reform Act of 1986, it is imperative that we give individual taxpayers, businesses, investors, and even government, some breathing room -- a chance to adapt. At this time, the single most important contribution to the tax code that Congress can make is prompt enactment of technical corrections to the 1986 Act; and the top tax policy priority at Treasury is completing the implementation of that Act, by issuance of regulations, rulings, and notices which provide taxpayer guidance.

It is especially important that we do not allow the tax reform accomplished in 1986 to be undone. In particular, we must maintain the low rates of taxation for both individuals and corporations. We must not let taxpayers be whipsawed by a tax law that is continually changing. Businesses as well as individuals require a stable tax environment in order to make sensible economic decisions. There are no more important ingredients to sustained economic growth than low tax rates coupled with the promise of certainty.

The summit agreement brings us much closer to a Federal government whose spending takes a relatively smaller proportion of GNP from the private sector. We are confident that the deficit can and should be reduced by continuing to shrink the scope of government through spending restraint and economic growth, rather than by tax rate increases.

Priorities

Last year's budget summit agreement was a major step toward consolidating these gains. That agreement conveyed two important messages to the American people. First, it demonstrated the willingness and the ability of the Administration and the Congress to work together constructively for the common good of the Nation. Second, it signalled that both the Administration and the Congress would not accept government spending set on automatic pilot via the sequestration process in the Gramm-Rudman-Hollings legislation. Make no mistake, automatic spending cuts are preferable to some alternatives, such as no spending cuts at all or higher taxes that slow the economy and undo the benefits of tax reform. But automatic cuts ignore priorities: Programs that may legitimately deserve additional funding are cut right along with those programs that may have outlived their usefulness.

The budget plan proposed by the President continues along the deficit reduction path. It complies with the summit agreement, completing the second part of the $76 billion deficit reduction package, and it provides funding for critical functions of government while cutting back or, in some cases, terminating funding of outmoded programs.

As agreed at the summit, the President's budget provides the financing for the core elements of our defense and international programs. Moreover, discretionary domestic programs will be permitted only a net increase of 2 percent over the level estimated for FY 1988. However, some programs, such as those for education, drug enforcement, and technology development receive larger funding increases, while others are reduced, reformed, or proposed for termination. Examples of programs proposed for termination include the rural housing insurance fund, the Economic Development Administration, Urban Development Action Grants, and Small Business Administration direct loans. The exercise of such priorities is consistent with the agreement and is an essential element in a dynamic Government's efficient adaptation to a changing world and changing needs.

An often overlooked element of spending control is the transfer of the provision of some goods and services from the Federal government to the private sector. It has become increasingly clear that the government and the private sector should do what each does best. The Federal government should not provide goods and services that can be more effectively and more efficiently produced by the private sector. Moreover, government actions and policies often interfere with the proper function of the private sector. A major theme of the President's FY 1989 budget is regulatory relief and privatization. It is important to note that the strategy of privatization does not necessarily imply the elimination of goods and services now provided by the government. Rather, it would make private alternatives available. In this way, it ensures the production of the goods and services actually demanded by consumers, not those chosen by the government.

The Budget Process

While we have experienced success in reducing the budget deficit, reforming the tax code, and releasing resources for private use, the budget process itself has lapsed into disarray. Last year the budget process failed to provide us with an opportunity to decide many important budget matters on their merits. The failure occurred despite the submission of a timely budget proposal by the Administration. This is not responsible governance. The budget process should be reformed, root and branch. In his legislative message, President Reagan has proposed numerous detailed reforms to the budget process, including adoption of a line-item veto, the balanced budget amendment to the Constitution with a super-majority vote required for tax increases, a joint budget resolution to be signed by the President to set Congressional budget priorities, and enhanced Presidential rescission authority. To help us make further significant progress in reducing the budget deficit, the Congress should act on budget reform this year.

Conclusion

We enter 1988 with cautious optimism. While the dramatic decline in stock prices last fall has clouded the outlook, the economy continues to exhibit considerable forward momentum. Employment growth remains strong and inflation is under control even as the economy shifts over to export-led growth and more emphasis on investment. The current economic expansion--the longest on record during peacetime--is displaying few of the imbalances that have jeopardized other expansions. The extraordinary length of this expansion does not necessarily imply an impending downturn as some analysts suggest. Expansions do not die of old age; they have typically been aborted by erratic and inappropriate policy changes.

The continued restraint of government spending in the President's FY 1989 budget is an extension of the policies that have promoted strong, sustainable, noninflationary economic growth. In confronting the uncertain events that will evolve in the coming year, it is imperative for us to resist additional government involvement as a solution to short-run problems. Such involvement has been unsuccessful in the past and ultimately becomes part of the problem rather than part of the solution. I am sure that by working together the Administration and the Congress can provide a budget that consolidates our hard-fought gains on deficit reduction without sacrificing funding for the necessary and important functions of government.

Chart 1

SHARES OF TOTAL BUDGET OUTLAYS

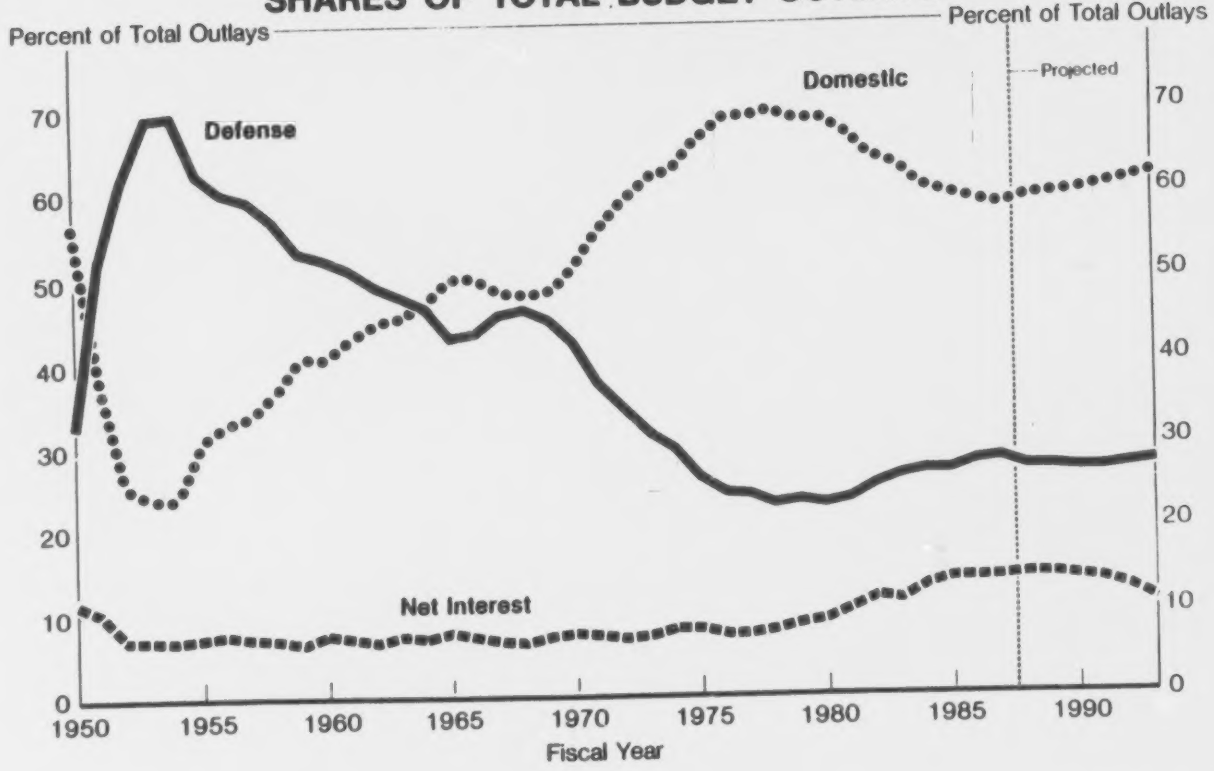

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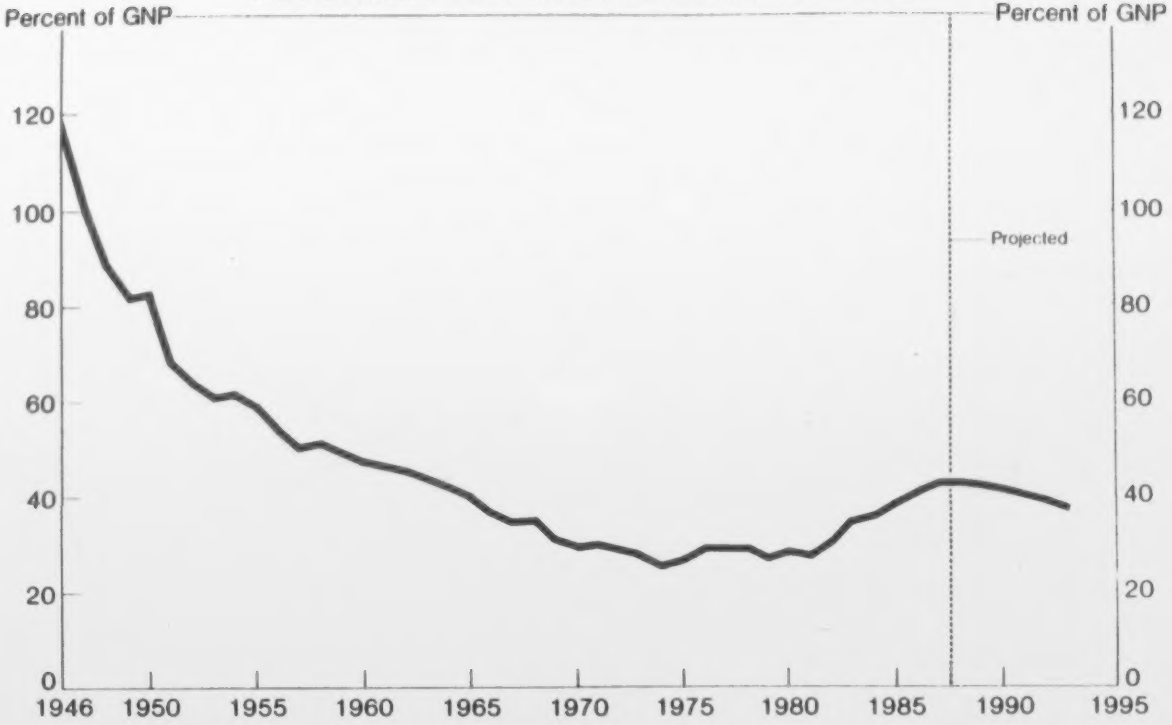
Chart 2

FEDERAL DEBT AS PERCENT OF GNP



Note: Debt held by the public, including the Federal Reserve.

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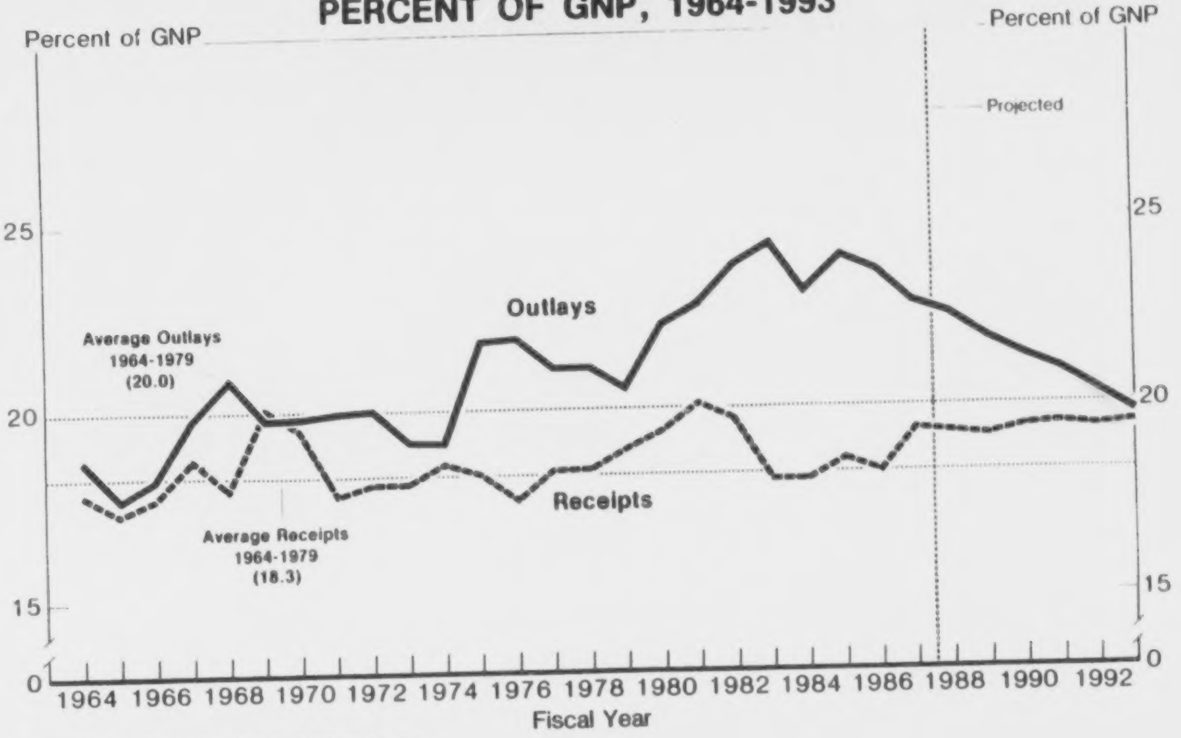
Chart 3

OUTLAYS AND RECEIPTS AS PERCENT OF GNP, 1964-1993



Note: Totals include off-budget receipts and outlays.
Data for 1988-1993 from FY 1989 Budget.

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Chairman **Chiles**. Last year, we were faced with two major program default crises. One involved the need to recapitalize the Federal Savings and Loan Insurance Corporation; the other involved shoring up the Federal credit system. In both cases, the Federal Government recognized its responsibility with respect to these institutions, and Congress and the President agreed on legislation to bail out these federally chartered institutions.

In both cases, we put the activities of these entities off-budget, as if the government has no responsibility for their financial activities. But in reality, everyone in town knows that in an exceptionally sour economy that spells trouble for these troubled corporations, Congress would not hesitate to step back in and pick up the pieces.

Already this year, I am aware of proposals to set up at least three to five more federally chartered corporations to perform a host of activities that ordinarily we would simply create a new grant or a direct loan program to fund. I am concerned about the amount of new Federal liability we are generating with off-budget institutions said to be private.

Does this trend of shifting cost off-budget concern you, and do you feel that we ought to do a better job of weeding out the prospective liabilities of various federally chartered corporations, so that those that are taken off-budget are institutions that truly are expected to have no direct Federal cost, even if they experience some hard times?

Secretary **Baker**. Yes, sir, Mr. Chairman, it does trouble us. I think we share your view, and we share your concern. We really don't believe that these off-budget government-sponsored enterprises are particularly useful. We know that they are not useful in presenting an accurate picture of the government's true liabilities or contingent liabilities. Quite often, they are used to hide governmental subsidies under a private sector label, and we don't favor that.

We did, however, support the creation of one in connection with the recapitalization of the Federal Savings and Loan Insurance Corporation. We think that was done for a very limited purpose. We think it was a salutary purpose. That should have been done, because we saw that as the only alternative to a direct taxpayer bailout of the Federal Savings and Loan Insurance Corporation. So we did support that undertaking.

But generally speaking, we share your concern.

Chairman **Chiles**. Earlier this week, I complimented the administration for its ability to implement a loan sale program that eventually achieved $7.4 billion in receipts in 1987. Considering the magnitude of the sales, I was impressed that the agencies were able to put together workable programs in a relatively short period of time.

I raised with you my concerns about one aspect of the loan program which the Federal Government intends to retain, and that is for up to 2 years, having a subordinated class of loans that are used to back up senior class loans that are sold to private investors.

Have you had a chance to look at that situation?

Secretary **Baker**. I have, Senator Chiles, and I am a little more familiar with that than when we had our colloquy before the Appropriations Committee. As I understand it, we don't put certain paper in a class A category and other paper in a class B category and sell the good and keep the bad. We put a lot of the financial assets into one pool. We then sell interests in that pool on a senior basis and a residual basis. And the people who buy the senior debt will have the first right to the funds that come in from the obligors on that paper.

We are not skimming off good, but we are carving out and giving to certain interests in the pool senior status. It is the view of my staff, and of the selling agencies' investment advisors, that we will receive as much, if not more, following this practice than if we simply tried to sell undivided interests in the whole pool of individual loans.

We have not as yet tried to sell any of the residual portion of the pool. We have a very good feel now for what the discount will be based on the sale of the senior paper, and at some point, we may see what the market will bring on the equity portion.

But because we are handling it this way, we will get a true picture of what concerned me, as you pointed out in the Appropriations Committee hearing, and that is that we really do need to know what this $234 billion portfolio of Federal direct loan assets is worth. We think this procedure will enable us to have a true picture of what it is worth.

Chairman CHILES. Well, that would still be my concern, and you have made it a little clearer to me how we do it, that we are not taking a better class of loans and putting them into the A. But as we haven't sold any B, we still don't have any idea what the true subsidy is. And I also would just worry a little bit about what happens to the next administration that comes in and maybe has a hatful of B and some of the As are gone, they have been sold.

Secretary BAKER. Well, again, let me simply say it is the view of the agencies' investment advisors and the domestic finance people at the Treasury Department that what we have received for the senior portions of the pools is at least as much as we would have gotten by selling undivided interests in the whole pools. They think this is a better way to go. It does not involve skimming off the cream of the loans and leaving the paper that has less of a credit rating or chance of being repaid.

Chairman CHILES. No. But as I say, until we sell an A and a B, we don't have any idea how much subsidy there was in those loans.

Secretary BAKER. Well, we do have an idea, because we know what we have gotten for the senior paper in the pools. If you assume that the residual isn't worth anything, a worst case scenario, that at least tells us that the discount isn't going to be any greater than that received on the sale of the senior portions. Furthermore, we have a residual of the pool that may be of some value.

Senator DOMENICI. Mr. Chairman.

Chairman CHILES. Yes?

Senator DOMENICI. I wonder if I could just ask one question. I have to leave, and I apologize for that.

Chairman CHILES. Yes, surely.

Senator DOMENICI. Mr. Secretary, I am sorry that I cannot remain. I have to go vote and then attend another meeting.

Let me just tell you I will submit some questions with reference to real interest rates and some others that I would like you to answer,[1] but I just want to ask you one general question now. In light of the continuing good economic news, including that which was reported this morning on unemployment, I wonder if you could answer this general question. Can the American market, as you view it, grow at a satisfactory rate and at the same time can interest rates come down, Mr. Secretary? Is that a scenario that you can envision?

I am fearful that if the economy holds up and unemployment comes down, we are going to get people thinking interest rates cannot come down. I hope that is not the case.

Secretary **Baker**. Senator, I understand your question, and I hope you will understand my reluctance to comment on the future course of interest rates. I have not done that in 3 years as Secretary of the Treasury, and I think it has been a good policy to follow. I just do not like to predict interest rates.

Senator **Domenici**. No. I don't think my question was that, and if you don't want to answer it, I totally understand. I am asking a general question, not a specific. I am not asking how much will interest rates come down. I am asking you can the American market grow at a satisfactory rate and interest rates come down under the current budget scenario?

Secretary **Baker**. It may be a bit premature to judge quite yet what the aftereffects of the market decline in October are going to be on the American economy. But many people, in the aftermath of that decline, predicted that we would be in a recession by now. In fact, some people have made the outrageous claim that we are already in a recession. We are not; the data support that very strongly.

That is the best way I know to answer your question. You may take this as a nonanswer, and if you do, I am sorry. But I don't want to predict rates.

Senator **Domenici**. I do, and you are sorry, and I forgive you. [Laughter.]

Chairman **Chiles**. Mr. Secretary, you were talking in your statement about the need for stability in the Tax Code, not undoing tax reform, and that the government needed this, and the business sector needed this. I kind of agree with that. But I keep hearing sort of dangling out to a lot of groups this talk about lowering the capital gains rate. That sets up certain expectations about changing the tax reform bargain. That is certainly again, when we are talking about allowing investments to sort of flow, everybody knowing what the rules are. If it looks like there may be some change in capital gains, I am going to do things differently, and I suspect a lot of other people are.

Are you ready to disavow any change in the capital gains, or is the President right now?

Secretary **Baker**. Well, what I am prepared to say is that we don't think that we ought to reopen tax reform, for the reasons that I mentioned in my remarks. Having said that, Senator Chiles,

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[1] See p. 223.

I have to tell you that our biggest disappointment in tax reform was that we were not able to maintain a differential for capital gains, because we think that it generates investment, and has been on balance a real plus, not being able to maintain that diffrential is something that we frankly regret. We recognized that this was one of the necessary costs of tax reform.

In the President's legislative message, he makes the point that he is really sorry we couldn't keep a differential capital gains and that a capital gains differential should be a cornerstone of any tax reform for the 1990s. That is what he says—any tax reform for the 1990s. I think that is fairly clear, and I would like to let the President's legislative message speak for itself.

Chairman CHILES. So then, you think it ought to be something that we look at in a tax reform of the 1990s and not look at it now?

Secretary BAKER. I quite agree with the President's statement in his legislative message. It ought to be the centerpiece of any tax reform for the 1990s, yes, sir.

Chairman CHILES. We have a vote going right now——

Secretary BAKER. There is nothing in the President's budget, as you know, that suggests consideration of it now.

Chairman CHILES. I am going to excuse myself just for a minute. We have got a vote going, and I will be right back.

[Short recess.]

Chairman CHILES. Mr. Secretary, I don't want to stop you from making news——

Secretary BAKER. I was filibustering in your absence, Mr. Chairman. [Laughter.]

Chairman CHILES. Mr. Secretary, as you know, we are in the final stage of passing trade legislation out of the Congress. You spoke about that in your opening statement. Throughout the trade debates, I have been pushing for a bottom-line approach to market opening, and the Super 301 now in conference kind of embodies that approach. It does force an administration to negotiate with countries who practice unfair trade, and if those negotiations break down, it does mandate retaliation.

Can you tell me what the administration's position is on this approach, and would the President veto the trade bill if the Super 301 appeared in it?

Secretary BAKER. All I would say on that, Senator Chiles, is that we have some reservations about that part of the bill. It has been the subject of discussions in recent days, I believe, between Ambassador Yeuter and members of Ways and Means and Senate Finance. He has the laboring oar on that particular provision in the trade bill, and I would really hesitate to go beyond what I have just said that is that we do have some reservations about it.

Chairman CHILES. I know a lot of us are frustrated with our lack of success in negotiating market opening overseas. Do you have any ideas on other ways that we can bring reluctant countries to the negotiating table and then walk away from that table with some real market opening reforms?

Secretary BAKER. Well, Senator Chiles, I think there is a fine line between what is one person's fair trade and what is somebody else's protectionism. In this trade bill debate we have to be extraordinarily careful that we don't opt for provisions which will result in closing U.S. markets. The way to improve our trade deficit is to open markets abroad. Anything that would lead us in that direction, we would support.

In February a year ago, the President sent a competitiveness package to the Congress which contained reciprocity as an additional item justifying a 301 case. This is the first time, I am pretty sure, that the President had subscribed to this. This is in the President's proposed competitiveness legislation. It is quite clear to me that the administration could support something along those lines. But the important thing is that we work toward opening other markets, not closing ours.

Chairman CHILES. I agree with that 100 percent.

Secretary BAKER. And having the threat of closing ours is one thing. We have suggested that reciprocity be an additional justification for initiating a 301 case.

Chairman CHILES. That is right. The answer is how do you get countries to open their markets if they sort of refuse when we just try to talk to them. I enjoyed very much what you told the South Koreans, and I think you put it very much on the line.

But I have really seen us do that same thing with countries over a period of years, only to watch the imbalance get greater and greater. The Japanese have been coming to my office since I got here. I watched the trade deficit go from $8 billion for them and had them wring their hands and say we are going to do something about it. When it hit $15 billion, we really exploded in this country at the time. And they said, oh, we understand that cannot go on. And now, we have watched it go on, and we sat here and allowed it to go on—not that market opening is the only thing that would help us with our trade deficit with Japan. I am the first to admit that we would still have it. But to have still all of these nontariff trade barriers and the other things that we fall into——

Secretary BAKER. Well, let me speak to that. I quite agree with you that our trade deficit is not attributable solely to the fact that we don't have access to the markets of some of our competitors to the same extent that they have access to ours. But, lack of access has adversely affected the U.S. trade balance.

In perhaps an advocacy way, Senator Chiles, I would argue that we have been aggressive enforcers of the unfair trade laws of the United States for the last 3 years. This is the first President in the history of the Republic who has ever self-initiated 301 cases. The President self-initiated a number of them, with some pretty good results in certain sectors for certain countries.

While I'm not sure whether we should be proud of this or not, he has granted more import relief, I think, than any other President. And yet, as you point out, the trade deficit continued to grow—past tense, because it isn't continuing to grow anymore. As I indicated in my opening remarks, it is beginning to narrow. Certainly, it is narrowing in volume terms, and we ought to be very pleased with that.

We have seen an absolute resurgence in our manufacturing sector in the United States. We are very price-competitive worldwide now. We are, as I indicated to the Appropriations Committee the other day, selling steel to Japan. I didn't think I would ever see that on my watch. The export sector is booming. This would be the worst possible time for the United States to go down the protectionist route and start closing our markets out of frustration with the extent of progress in market opening in other countries. We are making progress. It is hard work. But the way to do it, I submit to you, is the way that we are doing it, that is, through aggressive negotiation and aggressive enforcement of our unfair trade laws.

Chairman Chiles. Senator Nickles.

Senator Nickles. Mr. Chairman, thank you very much.

Mr. Secretary, welcome again.

If the windfall profits tax were repealed, do your figures show any revenue loss for 1988 or 1989?

Secretary Baker. The budget shows a slight revenue loss, Senator Nickles, for 1989 under the oil prices assumed at the time the budget was drafted. But if you use updated price assumptions, there would not be a revenue loss. That is how close the estimate was. I think the loss was $23 million.

Senator Nickles. I asked the same question of the OMB Director Mr. Miller, and I think he said, using current data, that there would be no revenue loss for 1988 and 1989.

Secretary Baker. I believe that is correct. If I remember correctly, the revenue loss in 1989 was *only* $23 million. For 1990, it was only $15 million.

Senator Nickles. I think he also showed that some of that $15 or $23 million was actually from previous year assessments, not from current year assessments on current prices. Isn't that correct?

Secretary Baker. I cannot speak to that; I do not know.

Senator Nickles. Well, current posted prices that producers are receiving in my State are $15.50, which is well below any threshold. The windfall profits tax, I think, is $19 or so.

Secretary Baker. That is true. The real issue there, I suppose, Senator Nickles, is what people think is going to happen over the course of the remaining months of 1988 and into 1989.

Senator Nickles. Well, I wish I thought we would be at $20 oil at the end of this year, but I am skeptical that that will be the result.

Let me ask you a question concerning the multilateral development banks. Do you have in the budget a significant increase for either those banks or the World Bank?

Secretary Baker. Senator, we have an increase for the World Bank in the form of a new general capital increase that will amount to about $71 million.

Senator Nickles. $71 billion?

Secretary Baker. No, no, no, no. Seventy-one million, million.

Senator Nickles. $71 million of additional commitment?

Secretary Baker. $71 million for——

Senator Nickles. I thought you had a multi-billion dollar package.

Secretary Baker. That's correct. But you asked me if we had any increases. There is, if I am not mistaken, $1.2 billion in the budget for all multilateral development banks. Most of that represents international commitments that the United States has made in good faith after consultation with the Congress. The $1.2 billion doesn't fulfill the full extent of our commitment. There will still be a considerable shortfall.

But your question, as I understood it, was what new increases do you have in the budget? The only one that comes to mind immediately is the general capital increase for the World Bank, which is $71 million of that $1.2 billion.

Senator NICKLES. And the total amount that you anticipate spending on outlays for multilateral development banks would be about $1.2 billion?

Secretary BAKER. That is correct, $1.2 billion.

Senator NICKLES. The U.S. percentage of the multilateral banks is what, some 20 percent?

Secretary BAKER. It varies from bank to bank. It is roughly 18.4 percent in the World Bank under the new general capital increase. The United States share is less in the Asian and African banks and more in the IDC. In the Inter-American Development Bank, we have a 34 percent interest, even though we contribute 72 percent of the resources. That is why we have not supported an increase in funding for the Inter-American Development Bank unless we get some reforms in voting procedures.

Senator NICKLES. I have discussed those with you in the past, usually in the Appropriations Committee, and I want to compliment you and encourage you in standing firm on making those reforms.

Let me ask you, I think there are some needed reforms. The World Bank yesterday approved a $400 million loan for steel development to Mexico; is that accurate?

Secretary BAKER. That is correct.

Senator NICKLES. What interest rate would be charged on that loan? Is that no interest rate for a few years, and then 5 percent?

Secretary BAKER. Oh, no. This is not concessional lending. The rate would be the regular rate that the Bank charges. It may be better than that from a commercial bank in the United States, but it will be in the neighborhood of 7 or 8 percent. This is not far from market rates. It is not concessional lending. It is not IDA money. It is what the World Bank would call a market rate.

Senator NICKLES. I realize the dilemma in Latin countries and that our Mexican neighbors have some problems. But I also realize that Mexico has a socialistic system where the government controls the oil industry, the banks. Does the government control the steel industry as well?

Secretary BAKER. Twenty percent of this loan will go directly to the private sector steel industry in Mexico and 80 percent to a parastatal, owned by the government.

But let me add, Senator Nickles, if I might, that Mexico is making very good progress in some areas. One area in which they are making extraordinarily good progress is in trade liberalization. They have joined the general agreement on tariffs and trade. They have opened up their trade regime. They have lowered their tariffs. One reason they have done this is because it has been a condition of World Bank loans that they have received over the course of the past couple of years.

Senator NICKLES. I didn't quite catch the answer to your question. Is the steel industry controlled by the government, owned by the government?

Secretary **Baker**. Partially. What I said was that 20 percent of this loan will go to the private sector steel industry in Mexico, and the rest will go to the public sector steel industry in Mexico.

Senator **Nickles**. I see my time is up. I have a real problem with the United States participating in loans—and I understand we voted against that loan, but like many loans, our objections are not adhered to. I have a hard time seeing U.S. taxpayers' dollars used to make loans, usually low-interest loans or lower than what could be obtained in the marketplace, or they would have obtained it in the marketplace, to firms that are controlled by a government, in other words, either nationalized or government controlled. That bothers me. I think that almost dooms the project to questionable success, whether it be Mexican oil or steel, or Columbia, or whatever. And then I have a hard time seeing making a loan for commodities, whether it be agriculture, steel, coal, other mineral production, that we have in many cases a surplus.

Thank you, Mr. Chairman.

Secretary **Baker**. Can I respond to that, Senator Chiles?

Chairman **Chiles**. Yes, please do.

Secretary **Baker**. I understand that, Senator Nickles. The point I want to get on the record here is that we have been working very hard to move countries toward free market economic reforms. It is the whole basis of our debt strategy. We work hard in the international financial institutions to achieve reforms and to achieve policy-based lending that emphasizes free market policies, because we really believe that this is the only way these countries are ever going to succeed.

We have worked particularly hard in the World Bank and also in the other multilateral development banks with respect to loans for commodities in surplus. We routinely oppose any loans for commodities in oversupply that injure U.S. producers. We are working in these banks to stop these kinds of loans from even getting started. We have been successful in this effort to the point that today, less than 5 percent of all multilateral development bank lending involves sensitive commodities.

Senator **Nickles**. Is steel a sensitive commodity?

Secretary **Baker**. Yes.

Senator **Nickles**. So we weren't successful in this case?

Secretary **Baker**. It is part of the less than 5 percent. We were not successful in stopping this loan, but we have been successful in getting the World Bank and other banks to reduce the amount of sensitive commodity-type lending that they will consider. And we have been, I think, very successful.

As a matter of fact, we did not agree to support the new general capital increase of the World Bank until we got some agreements from the World Bank management that steps would be taken to reduce their concentration or emphasis on sensitive commodity lending.

So, we are making progress. And I submit to you that we are in a better position to make progress in this regard if we do not effectively opt out of these institutions by not contributing the share that we have agreed to contribute, or by not supporting additional capital increases.

Chairman **Chiles**. Senator Conrad.

Senator **Conrad**. Thank you, Mr. Chairman.

Welcome, Secretary Baker.

Is it your view that the summit agreement provided sufficient deficit reduction?

Secretary **Baker**. Sufficient for what, Senator Conrad?

Senator **Conrad**. Sufficient for the health of this economy.

Secretary **Baker**. Chairman Chiles and Secretary Baker and the ranking member Senator Domenici, and President Reagan, and everybody else involved in that summit agreement at the time said that it would have been great if we could have gone further, but this is what the system could support. It is good, solid deficit reduction for 2 years of roughly $76 billion, and I would submit to you that only about $10 billion of that could you call blue smoke and mirrors in the form of, let's say, asset sales. The rest of it is real. I think it is a significant accomplishment, and I think if you pass the President's budget, and if you look at the assumptions that are in it, you will see that the deficit of the United States will be reduced to four-tenths of 1 percent of GNP in 1993.

So in that respect, yes, I think it was sufficient.

Senator **Conrad**. Is it your view that the deficit is actually going down on a year-to-year basis as a result of that agreement?

Secretary **Baker**. It is going down on a current services basis as we sit here today, whether you pass the President's budget or not. If you would pass the President's budget, it would go down even faster.

Senator **Conrad**. Mr. Greenspan, who was here yesterday, said that he believed the deficit would be going up on a year-to-year basis. Do you disagree with his prognosis?

Secretary **Baker**. I haven't seen any report that he said that, but I would disagree with that. Our estimates don't support that.

Senator **Conrad**. Have you looked at CBO's analysis that says the deficit is going up?

Secretary **Baker**. Yes, I have seen that. I don't agree with that one bit. I don't think anybody ought to agree with it, based on our experience. CBO said somewhat the same thing last year, and they were wrong. In my view, Senator Conrad, they are going to be just as wrong this year. And so far, the recently-released data bear that statement out.

Senator **Conrad**. How much of the deficit reduction that the President demonstrates on a year-to-year basis is because of increase in the social security surplus?

Secretary **Baker**. I haven't split that out. We are well aware of the fact that the deficit contains a surplus in the unified budget from the Social Security and other trust funds.

Senator **Conrad**. In your recollection, what was the total public debt when this administration came to office in dollar terms and as a percent?

Secretary **Baker**. The public debt at the time we took office was about 27 or 28 percent of GNP. I remember that under the Johnson and Kennedy Administrations, it was about 46 percent. And today, it is 43 percent.

Senator **Conrad**. No; I am talking about the total national debt now.

Secretary **Baker**. That is what I am talking about. I am talking about it as a percentage of GNP; it was 46 percent of GNP under the Johnson and Kennedy administrations. It is 43 percent of GNP today, Senator.

Senator **Conrad**. Do you recall what it was when you came into office?

Secretary **Baker**. It was around 27 or 28 percent.

Senator **Conrad**. Twenty-eight percent?

Secretary **Baker**. It was 27 or 28 percent of GNP.

Senator **Conrad**. And in dollar terms, do you recall what it was?

Secretary **Baker**. No, sir, I do not. But I think the appropriate way to look at the Federal debt, if I may say so, is as a percentage of GNP.

Senator **Conrad**. I certainly think that has merit. So we are saying it has gone from 28 to 43 percent during this period.

Secretary **Baker**. Right.

Senator **Conrad**. In dollar terms, I think, something under $1 trillion, in the $900 billion range, something like that?

Secretary **Baker**. To about $2.0 trillion held by the public, or $2.4 trillion gross.

Senator **Conrad**. That is where we are today, $2.4 trillion. What is your anticipation of what the debt will be in 1992 if this plan is carried out, both in dollar terms and as a percentage of GNP?

Secretary **Baker**. Well, I don't know that I have it in dollar terms, but let me give it to you as a share of GNP. This year, 1988, the public debt of the United States is 43 percent. That is excluding what the United States owes itself. I am not talking about the $2.5 trillion now; I am talking about $2.0 trillion, that is, excluding trust fund debt, which is just something we owe ourselves.

In 1992——

Senator **Conrad**. If we were to take total national debt, we would be at, what, 54 percent of GNP?

Secretary **Baker**. I don't have that percentage. But, I don't think that is a proper way to measure it, because that includes trust fund debt, which we owe to ourselves. To answer your question, under the President's budget, the debt would decline 4 percentage points to 39 percent of GNP by 1992.

Senator **Conrad**. And the total national debt would be something in the range of $4 trillion in dollar terms?

Secretary **Baker**. Well, perhaps. I don't have that number at hand. But our gross national product will be considerably larger than it is now, if we continue to adhere to the proper policies.

Senator **Conrad**. Well, my time has expired. I hope we can get back on this question when we have a little more time.

Chairman **Chiles**. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman.

Mr. Secretary, I must compliment you. As you know from discussions in the past couple of years, I have been skeptical of some of your statements that tended to push the dollar one direction or the other. But I have to say that it appears to me you have gained the respect of the international financial people around the world. Probably not since William Simon was Treasury Secretary have we had one who has enjoyed the high regard worldwide that you have, and I compliment you for that.

I want to report to you also that one reason I am so pleased is there are 4,400 more people working in Idaho, as of November 1987, than there were in November 1986. As you know, in a commodity-based economy, we have had a real struggle in Idaho, as all commodity sectors have worldwide. One of the biggest problems we have right now is a shortage of railcars to haul the grain out—I think it is positive that we are dealing with those kinds of questions. So I compliment you on your persistence to stay the course.

The first question I want to ask you is what would happen to interest rates and the cost of capital to farmers and small businessmen if foreigners started to pull their money out?

Secretary **Baker**. Senator Symms, we had a colloquy on this before you got here, but not with respect to the impact on interest rates. I think—and I believe Chairman Greenspan testified to this a day or so ago—that we should resist efforts to screen foreign investment in the United States, or to throw up barriers to foreign investment in the United States, because this could very well result in higher interest rates.

Senator **Symms**. I agree with you, and I just wanted to get that on the record. I think that it is better for us if they invest in fixed assets. It does take longer to remove capital than if they are in more liquid assets. That has been the thing that always appalls me about the Congress, that some Members want to stop them from investing in fixed assets, but they will let them put money in the bank, which they can take out in 5 minutes.

Secretary **Baker**. You are absolutely right, Senator. Not only that, investment in fixed assets generally creates jobs, creates output and creates technology in the United States.

Senator **Symms**. The next question I want to ask you is about social security. I have an article before me here by Stewart Sweet, who used to work on the Hill, and he says, "Contrary to conventional belief, the Reagan administration will leave its successors with a stream of budget surpluses beginning in 1994. The cause of this stunning reversal of budgetary fortunes comes from the 1983 Social Security Amendments. Those reforms were so powerful that the Social Security Administration itself projects a cumulative surplus of $12.4 trillion by the year 2030."

Number one, do you agree with that; number two, if that is the case, would you recommend that we not raise the payroll tax in 1988, and 1990?

Secretary **Baker**. Well, let me answer the first question before you get to the next one. Yes, I agree that the projected surplus by 2030 is $12 trillion.

Senator **Symms**. Well, Senator Packwood has been speaking about this. He has numbers, and he was quoted in the BNA Daily Executive Report the other day as saying the Social Security Administration statistics indicate the trust fund surplus will grow until it is sufficient to counter the entire Federal deficit. He said, quote, so you will not have to float bonds in the private markets; for the 10 years after that, the surpluses are so great that there are enough funds to retire all the past debts of the United States.

Secretary **Baker**. Well, of course, that depends on realizing the assumptions made today, and on the conclusions of the actuaries remaining the same. I cannot speak to that number for the year 2030.

Regarding whether I think we ought to repeal the payroll tax increase, do you mean the one that is already legislated?

Senator SYMMS. Yes.

Secretary BAKER. You know our position on taxes, Senator Symms, whether they are on income or payroll. I think, however, that this particular increase is a part of, or results from, the 1983 Social Security Commission compromise that we worked out on a bipartisan basis between the leadership of both political parties in this country.

Senator SYMMS. But you do think there is a potential that this deficit problem is not what it is created to be politically—in other words, everybody always talks about the deficit in a partisan way. I guess what I am getting at is I am always amazed our friends on the Democratic side of the aisle continue to say that the 1981 tax bill is the cause of the deficit, when in fact, revenues have increased by 65 percent—general revenues, I am speaking of—since 1980.

Secretary BAKER. That is right.

Senator SYMMS. The reason we have a deficit is because inflation was stopped, and there wasn't that profit to the government anymore with no more inflation and the indexing of the Tax Code. Even at that, though, revenues grew.

Do you think the reason that people still continue to say tax cuts caused the deficit is that the news media just continues to repeat it, and we have all these hand-wringers out there, talking about how terrible everything is?

Secretary BAKER. Well, Senator Symms, I think part of it is the fact that this is 1988, and that is understandable. But I quite agree with you——

Senator SYMMS. What does 1988 have to do with it?

Secretary BAKER. Well, it is one of those every-4-year cycles that we go through in this country.

Senator SYMMS. We are talking about elections?

Secretary BAKER. That's right.

Senator SYMMS. Okay.

Secretary BAKER. But let me say this on the substance of the point you are making. If you pass the President's budget, the deficit will be reduced to practically nothing by 1993 without raising taxes. This year, it will be reduced to 2.6 percent of gross national product, which is very reasonable.

Yes, the deficit will continue to appear large in nominal terms. But the deficit is declining on a current services basis. It is going down anyway. And if you would simply pass the President's budget, which this year represents 2-year budget agreement between the executive and legislative branches, the deficit will decline to those very, very small amounts in the outyears.

So I have to agree with you that a lot of the debate—well, much of it in any event—is political as well as being to some extent economic.

Senator SYMMS. Thank you, Mr. Chairman.

Chairman CHILES. Senator Sasser.

Senator **Sasser**. Well, Mr. Chairman, I guess I have heard it all now. It comes full circle to hear my colleagues from the other side of the aisle here saying that the members of our party are being political for lamenting the fact that we are running record high deficits here in this country, and the fact that we have doubled the national debt over the past 7 or 8 years.

We can talk all we want to about debt as a percentage of GNP and compare Kennedy and Johnson, their percentage of GNP deficit to that of this administration. But the Secretary of the Treasury and I both know that there is a big difference. Kennedy and Johnson were financing their deficits internally. They were not going abroad, becoming dependent on foreign capital to finance up to 50 percent of the borrowing to take care of the government deficit. That is what we have been seeing over the past 7 or 8 years, and to some extent, I find that our interest rates and our monetary policy are held captive by the Japanese and others, whose money we are dependent upon to finance our deficit.

I just could not let some of this go by without commenting on it.

Now, Mr. Secretary, the administration is projecting a budget deficit of $129 billion. If we miss that target and get up over $146 billion, then we are going to trigger the Gramm-Rudman-Hollings sequester, and that is a matter of concern, I think, to all of us.

I think we both agree, you and I, that before the Administration and the Congress would let sequester kick in, if we get to that point, that we would probably be better advised to convene another economic summit and try to come up with a deficit package that would get us below those Gramm-Rudman-Hollings targets.

Are we in agreement on that? Rather than have sequester in the event we get above the targets, we would have another summit and try to come below it?

Secretary **Baker**. Well, Senator Sasser, that question came up in a leadership meeting about 2 weeks or so ago with the President. It is our view that we ought not to assume that we are not going to hit the targets, because we think we are. And therefore, we really ought not to decide today what we might do if we don't hit the targets.

The possibility of a sequester brings a certain amount of discipline to the system. I think the fact that we were facing a sequester last fall was one of the reasons we were able to hammer out the budget summit agreement. So, I don't think we ought to take the view that under no circumstances are we going to let sequestration take place; we ought not to do that.

Senator **Sasser**. Well, now, the administration is not acting in concert on this, Mr. Secretary. As you may know, the Director of the Office of Management and Budget was up here 1 or 2 weeks ago, and he indicated—and I don't think I am misquoting him—that before we got the sequester situation, that it was his view—and I assume he was speaking for the administration—that we ought to have another budget summit before letting sequester take place.

Secretary **Baker**. Well, let me just comment on that. I am not saying that we should not consider that, because I think the summit was the appropriate course last fall, and I think we were successful. But, we should not say today that this is the way we are going to go, and under no circumstances will we have sequestration.

Senator **Sasser**. On page 3 of your statement you make the point—and I think it is a valid point—that domestic demand in the economy is slowing down due to, quote, "lagged effects of a more cautious monetary policy during the last spring and summer," close quote, a more cautious monetary policy followed by the Federal Reserve Board.

Now, the Fed in its recent monetary policy report indicates it is going to be tightening the growth of monetary aggregates by one-half of a point for 1988, and if the Fed should err on the low side of its monetary targets, we are going to see monetary growth that could be substantially lower in 1988 than it was in 1987.

Now, my question to you, Mr. Secretary, is: Is this a prudent policy for the Federal Reserve Board to follow? Don't we really need a monetary policy that is more accommodating, one that will help us sustain economic growth through 1988 and beyond?

Secretary **Baker**. Senator Sasser, let me say that I am in fundamental agreement with the conduct of monetary policy that is presently being pursued by the Federal Reserve. I think that the unemployment data released this morning indicate the propriety of that policy. There really is no difference of opinion or difference of view between the administration and the Federal Reserve with respect to its current conduct of monetary policy.

Senator **Sasser**. Well, Mr. Secretary, it appears to me—and I see my time is up—but it appears to me that one of the great legacies of this administration is going to be to deprive a future administration, whether it is Republican or Democratic, and future Congresses of the ability to stimulate this economy through fiscal policy if we start falling off into a recession. And we are going to lose that ability because of the enormous deficit legacy that is being left by the present administration.

Now, that leaves us with only one arrow in our quiver, as I see it, and that is the tool of lowering interest rates, the tool of monetary policy. And if we get into a posture here where we cannot count on the Fed to assist us on the monetary policy end of it, I think we could be in big, big trouble.

I want to ask you this. In the event—and I am not asking you to say that, yes, we are going to convene an economic summit if we miss the Gramm-Rudman-Hollings targets—but in the event that we do miss the targets, and in the event that the leadership and the Congress and the administration find that it is the better part of valor to convene another economic summit, if we are really looking for long-term economic growth, what do you think about the proposition of getting the Chairman of the Federal Reserve Board to participate in that conference? I think they are going to have to be major players, and it appears to me they are going to have to be in on the take-offs as well as the crash landings over the next 2 or 3 years.

Secretary **Baker**. Let me just say, Senator Sasser, that I personally would welcome that, because I have worked very closely with Chairman Greenspan, as I think I did with Chairman Volcker. And I don't think that is an inappropriate idea at all.

I must add that in saying that, I don't want to be perceived as saying we ought to start talking now about another budget summit agreement, because we don't think that the "Apocalypse Now" scenario you have painted is what is going to happen. We have heard that since 1983, and it has not happened. And we don't think it is going to happen.

And if I might say so, Senator, with all due respect—and I really mean that I have a great deal of respect for you—I don't think it is quite fair to say the deficit legacy left by the present administration.

We have not controlled either House of the Congress for a couple of years. Fiscal policy is made by the executive and legislative branches together. The President, though, as you know, cannot spend a dime. The Congress spends; the President does not. If you pass the President's budget, there won't be a deficit legacy. But, if indeed there is one, I hope you would agree with me that at least it is a shared responsibility between the legislative and executive branches.

Senator **Sasser**. Well, let me say this, Mr. Secretary, and then I will cease, Mr. Chairman.

I have the highest respect for the Secretary of the Treasury. I think he is one of the ablest members of this administration and has conducted himself very well over the past 8 years. But I must say to you, Mr. Secretary, that I believe history is going to disagree with you on this one.

Chairman **Chiles**. He just believes in the tooth fairy, that's all.

Senator **Wirth**. Thank you very much, Mr. Chairman.

Mr. Secretary, I want to join in welcoming you here and thank you very much for being here and spending so much time with us.

I want to start out by surprising you, and that is by associating myself, as I always do, with the comments of the junior Senator from Idaho in complimenting you on the job that you have done and the respect that you have not only here in the Congress but, I think, around the world.

Also, I came in just as there was a brief discussion of the vote on the loan to Mexico. I just wanted to record for the record what you are very familiar with, the fact that there are a lot of us who disagree with the vote that you took and the position that apparently our government took on that. I think some of the earlier discussions on that got a little bit skewed and that you might have gotten a little bit of the wrong impression about what the perspective up here was. I think that got reflected in the vote the night before last on the floor, where I think there was a one-vote difference. So it was a very close margin, and I guess I was a little bit surprised by the vote you cast.

But I just wanted to point out for the record that there are many of us who saw that in a little bit of a different way.

Secretary **Baker**. Thank you, Senator Wirth.

Let me say that we were pleasantly surprised by the results of that vote, but the determination had been made before the vote was held——

Senator **Wirth**. I understand that, I understand that.

Secretary **Baker** [continuing]. And frankly, we didn't know that the vote was even going to be taken.

Senator **Wirth**. Well, there are lots of us up here who understood that I think you got a little bit boxed on that, and we understand that. There was a good deal of sympathy for the problem that you got yourselves into on that front.

Also, I would ask you if you might get your staff to take a careful look at the bill that just came out of the Banking Committee on bank powers and so on. There are some areas toward the back of that legislation that focus on the Brady Commission Report, the GAO Report, and what Senator Bob Gramm of Florida and I have called the harmonization of the regulatory pattern. And we are asking the Secretary of the Treasury to sit down with the SEC and the CFTC and probably some other players, and to come back to us with your view of the gaps that exist, the overlap that may exist in regulation, and the regulations that you think we ought to pursue.

I am not asking you to comment on that now, but I think it is a very important set of steps. I think you are going to have to take a major role in that. I know how interested you are in that area, and I just want to commend that to your attention and sort of raise up the level of priorities a bit, if I might.

Secretary **Baker**. Thank you, sir. We agree with you that it is a very important area.

Senator **Wirth**. Third—and I do not want to get into the discussion and battle over the domestic deficit, but talk a little bit about long-term investment that we are going to have to make.

It seems to me we all agree, whether we read "The Nation at Risk" or we look at our need to make ourselves more competitive and more productive in an increasingly competitive world environment, I think we are all aware of the fact that we are going to have to make some pretty significant investments in ourselves in this country in the future, in education, research and development, universities and so on. I don't think there is any disagreement downtown with that.

Secretary **Baker**. That is right. And in fact, if you look at the elements of this budget, Senator Wirth, where domestic discretionary spending has increased, it is in those areas.

Senator **Wirth**. I think we are probably going to have to do significantly more. I think most people looking at Head Start, at early childhood development programs, looking at illiteracy in the country, looking at the aging structure of a lot of our university research facilities—we are probably going to have a lot more investment to make.

And the question is where are we going to find the savings to invest in that. And that is going to be the question not only for 1988 and 1989, but probably for the rest of this century—where are we going to accumulate the savings to put into that kind of investment which is crucial to our future?

Isn't that in a broad sense correct?

Secretary **Baker**. Yes, I agree with that.

Senator **Wirth**. And we are not very good at sort of national savings, I guess. As a country, we don't save very much as individuals—unlike the Japanese, for example, where there is a lot of individual saving. So probably, we are going to have to find some way in which we are going to have to have public savings to meet those needed investments in the future.

Secretary BAKER. That is right; I agree with that, Senator.

Senator WIRTH. And then the question is where do we get those public savings. And one of the areas that I find very attractive and that we have been talking about a lot in my home State of Colorado and with a lot of other groups is the possibility of looking at some kind of consumption tax or a value-added tax and tying that to the need for long-term investments in the country.

The question that I have of you is—I want to disassociate this in terms of the current budget battle and so on and just to talk, if we can, in a dispassionate way about a value-added tax—if you could describe your views as to whether or not that is an equitable kind of a tax, you know, what its virtues are and what its negative are; and finally, if you might comment on how you think that might relate to our trade situation. There are some who argue, I think pretty persuasively, that a value-added tax helps us to compete in an international economic environment.

Secretary BAKER. I will be glad to do that on a purely hypothetical basis, Senator Wirth.

Senator WIRTH. I understand that.

Secretary BAKER. Let me preface my remarks by saying that the administration is not just opposed, but strongly opposed, to a value-added tax because it represents such an engine for revenue growth that the temptation to raise the rate is almost irresistible. Therefore, the temptation to expand the percentage of the economy that the government takes is almost irresistible.

Some criticize a value-added tax on the grounds that it is regressive, as well. Would it discourage consumption? I think it absolutely would compared with our current tax code. Would it perhaps be beneficial in terms of our trade deficit, provided it was rebateable at the border? I think it would.

Senator WIRTH. That is how you would design it; that is what every other country has done with one.

Secretary BAKER. Yes, every other country has done that. And that is one of the strong arguments, I suppose, that the proponents of such a tax make in support of it. That would be my view. I must tell you, however, that we are fairly firmly opposed to the value-added tax.

Senator WIRTH. Oh, I understand the position, but looking at it in the abstract, taking it out of any political context, it seems to me that there are——

Secretary BAKER. Not just politically opposed, we are also economically opposed, Senator, for the reasons that I mentioned at the outset. It would be an almost irresistible temptation for our elected officials to move that rate up. Even if there were a consensus that the economy could sustain a low-level value-added tax, I don't think the rate would remain low very long.

Senator WIRTH. Well, the Governors often make that argument as well, saying that that kind of a tax is tied to State revenues and not something that we ought to use.

I appreciate your views and hope we have a chance to come back around. Thank you very much.

Thank you, Mr. Chairman.

Chairman CHILES. Thank you.

Senator Grassley.

Senator **Grassley**. Mr. Secretary, I have some questions on trade I want to ask, but before I do that, I want to compliment the administration on its record of peacetime economic expansion. I believe this now is the 64th month, and you mentioned that in your statement, and I don't think there is anything wrong with emphasizing that, because something is working right, even though we all do not like and still consider very serious the budget deficit that faces this Nation.

Last fall, a noted Japanese economist predicted that the dollar would fall no lower than 125 yen to the dollar. At that point, he felt that the Japanese banks would intervene to prevent it going any lower. Yet the dollar continued to fall, and it dropped to a low of 118, I believe it was.

Today it is back up to about 127. Where do you see the value of the dollar going in the next few months?

Secretary **Baker**. Well, Senator, I am not going to comment on that beyond saying that we have agreed with our trading partners, the other industrial nations of the world, on December 22 that any further decline of the dollar could be counterproductive.

We think it is in the interest not just of other nations around the world, but also in the distinct interest of the United States, that we see stability in exchange rates.

Senator **Grassley**. You mention in your statement on page 7 some trade negotiations that might produce some preliminary results to report this fall, and it was nice to read that some of these might come in the area of agriculture.

Could you elaborate on these?

Secretary **Baker**. Give me that reference again, Senator Grassley.

Senator **Grassley**. Page 7.

Secretary **Baker**. Well, one of them mentioned is the Free Trade Agreement with Canada. The President, as I indicated before you got here, Senator Grassley, has been for the last 3 years very aggressive in enforcing the unfair trade laws of the United States. He is the first President in history to self-initiate 301 cases or unfair trading cases against some of our trading partners, and while I am not sure we ought to be particularly proud of it, this administration has probably granted more import relief than any other administration.

It is those instances that I am referring to. I will be happy to supply you with a list of the countries and the specific market opening measures that we were able to obtain.

Senator **Grassley**. Now, is what you just said in answer to the part of your statement that said "particularly in the very important area of agriculture"?

Secretary **Baker**. Well, I am looking at the statement where it says, "In the area of trade policy, the administration has gone to unprecedented lengths to open up foreign markets, although these measures, of course," and so forth.

Where are you on that page?

Senator **Grassley**. Page 7, the second paragraph from the bottom, the middle of that paragraph.

Chairman **Chiles**. Why don't you read it?

Senator **Grassley**. "We hope, through a mid-term review, to have some preliminary results this fall, particularly in the very important area of agriculture."

Secretary **Baker**. Oh, what I am referring to there is the Uruguay Round. We have been very anxious—as I know you would agree—to see multilateral trade negotiations include the problems of agricultural trade. We see agricultural trade as the number one trade problem facing the world. We were successful in getting that on the agenda of the Uruguay Trade Round; it is that process that I am talking about in that part of my statement. We hope that progress will be made in those multilateral discussions which will ultimately move us toward a medium- or long-term solution to the agricultural trade problem of the world.

Senator **Grassley**. What do you see the Free Trade Agreement with Canada doing as far as opening up doors for further Free Trade Agreements; any plan along that line?

Secretary **Baker**. I think if the Parliament in Canada and the Congress of the United States implement and support the agreement, I really do believe that it could open up possibilities for additional Free Trade Agreements. We have had other countries approach us in the aftermath of the negotiation of the Canada-United States Agreement to discuss possible Free Trade Agreements with us.

Senator **Grassley**. How much of the expansion in exports is directly related to the lower value of the dollar as opposed to other things we might have done or other things that happened in the world climate?

Secretary **Baker**. I don't have a percentage for you, but I will be glad to submit that to the staff, Senator Grassley, and see if we can come up with a rough estimate. I think, however, that would be pretty hard to do.

Senator **Grassley**. Okay. But if you could, I would appreciate it.

Secretary **Baker**. I'll try.

Senator **Grassley**. What action is the Administration willing to take to ensure that the dollar does not fall or rise too fast and dampen this export growth that we are now enjoying?

Secretary **Baker**. Well, as I said earlier, stability of exchange rates is very important, not just to the United States but to our trading partners as well. We have for some time been coordinating our economic policies with the other G-7 countries. We will continue that process. We do it periodically and we expect to continue it in such a way, Senator Grassley, as to promote or foster stability of exchange rates.

Chairman **Chiles**. Mr. Secretary, I think you have indicated that you need to leave by a quarter to twelve; is that correct?

Secretary **Baker**. I have a meeting at the White House at noon, Senator Chiles, if that is all right.

Chairman **Chiles**. Fine. We will try to accommodate that.

I have just a couple more questions. In the latest Louvre Accord, we seem to have been pretty successful in stabilizing the value of the dollar. The strength of the accord, however, will have to depend on how well we coordinate our economic policies with those of our trading partners.

What commitments have we made to foreign countries as far as part of this agreement? Have we agreed to support the dollar near the current levels, and what have they promised to do in return?

Secretary **Baker**. Well, we have agreed to cooperate with other countries on exchange markets. We have agreed to continue to resist protectionism. And we have agreed to take action with respect to the fiscal deficit of the United States.

Other countries, as I indicated in my opening remarks, have made somewhat similar agreements, that is, that they would cooperate with us on exchange markets, Japan has agreed to increase its domestic demand and continue to promote the policies which it has implemented and which are resulting in an increase in domestic demand; Germany and the other G-7 surplus countries have agreed to adopt similar policies.

Chairman **Chiles**. I was just listening, and I did not hear in there what you said about supporting the dollar.

Secretary **Baker**. What I said was that the Group of 7 countries in the December 22 statement have agreed to cooperate on exchange markets to foster exchange rate stability.

Chairman **Chiles**. Different interest rates across countries have a lot to do with where investments flow and what happens to exchange rates. If our interest rate keeps falling, will our partners allow their interest rate to fall with ours? Isn't it essential that they do so if we are to finance our trade deficit at the current level of the dollar?

Secretary **Baker**. Well, let me just refer you to Chairman Greenspan's statement to you yesterday, Senator Chiles, that there is no secret G-7 agreement on interest rates.

Chairman **Chiles**. Then I have to ask you is there a secret agreement on support of the dollar?

Secretary **Baker**. Well, I just told you that on December 22, the seven countries agreed to cooperate on exchange markets to foster exchange rate stability. But there is nothing secret about that. It is in the communique which was released on December 22.

Chairman **Chiles**. Mr. Secretary, the Treasury Department is responsible for requesting funds for the multilateral development banks. In the fiscal year 1989 request, you ask for over $1.3 billion in U.S. contributions to these organizations. I support the work of the banks, and I believe that the U.S. contribution not only helps Third World nations pursue their own economic development, but it serves in our national interest.

However, I noted your request avoids dealing with over $400 million in arrears to these institutions. Instead, your request suggests that these additional sums will be requested in 1990. Aren't you underestimating the true cost of our involvement in these banks by maintaining these large arrearages? Isn't this another example of sort of laying off the true cost of this term until the next term?

Secretary **Baker**. Senator, do you remember how many days we spent fighting for a little more money for the 150 account in the budget summit agreement? If you had given us another $400 million, we might have been able to cover those arrearages, but we cannot, because we ran out of money under the budget summit agreement in the 150 account.

So we are asking for what we can. Had we had more latitude under the budget summit agreement, the administration would have requested funding for the full backlog, because these are commitments that the United States has made—international commitments made in good faith after consultation with the relevant committees of the Congress. That is why it is not in the budget.

Chairman **Chiles**. Senator Conrad.

Senator **Conrad**. Thank you, Mr. Chairman.

Mr. Secretary, you know, when I was growing up I was taught if you ever get in trouble, get yourself a Philadelphia lawyer. And what I have learned today is that if I get in trouble, I should get myself a Houston lawyer, because you have done a superb job of taking a total losing case and making it sound like a winner. [Laughter.]

Secretary **Baker**. Thank you, Senator, but I do not agree with you about the case. It was easy; the case is a good one.

Senator **Conrad**. No, it is an abysmal one. And I just take my hat off to you. Here we are—we have gone from $900 billion of national debt to $2.8 trillion under this administration. Gross debt, we have gone from 34 percent of GNP to 56. The deficit, according to Mr. Greenspan yesterday, is going up on a year-to-year basis even though we all heralded across the country that we reduced the deficit $76 billion. And the public will be mighty surprised to find out that the $76 billion was off a projection; it wasn't off of what the deficit was the previous year.

You compared the debt as a percentage of GNP back in the Johnson and Kennedy years. I think just for the record, we ought to make clear the differences.

In those days, real interest rates were 2 percent. They are 2½ times that now. We had a trade surplus instead of a trade deficit. In fact, the trade deficits increased sixfold in this last 8 years, and as a result we have gone from being the world's largest creditor nation, which we were then, to being the world's largest debtor nation, which we are now.

But I do salute you for doing a splendid job of making a good case out of it.

I think it is important that we relate to the point that Senator Symms made, because I think people are going to be awfully surprised if they are looking at the social security surpluses as our salvation. It goes to your position that the gross debt isn't the thing we ought to look at because we owe it to ourselves. Indeed, we do.

Those social security surpluses, of course, are being used to offset the operating deficit. The money is gone. There is a bookkeeping entry, but the money is gone. Those surpluses are on paper.

So it seems to me quite clear that this economic policy cannot be sustained. Senator Grassley said we have had this tremendous period of economic expansion. Absolutely. We have had the most massive use of public debt probably in world economic history to sustain that—certainly, in our history—I am sure you would agree with that——

Secretary **Baker**. No, sir—well, we had federal debt held by the public of 100 percent of GNP at the end——

Senator **Conrad**. 120 percent at the end of World War II.

Secretary **Baker**. Right, measured as gross federal debt.

Senator **Conrad**. But that was a world war.

Secretary **Baker**. Okay, well, then, qualify your statement by saying in peace time. You said the most massive use of public debt we have ever had in history. That is not true.

Senator **Conrad**. We had circumstances quite different, I am sure you would agree.

Secretary **Baker**. Yes.

Senator **Conrad**. That was to fight a world war in which our survival was at stake. We have not had anything like that in this period.

Clearly, this is not something that can be sustained. Alan Greenspan, who I think is someone you respect, was here and stated categorically we cannot continue this policy, that the deficit must be further reduced.

Secretary **Baker**. I agree with that; it must be.

Senator **Conrad**. Why don't you propose, then, something more aggressive this year than sticking with the summit agreement?

Secretary **Baker**. Well, let me just comment on a couple of those things, Senator. Number one, if you simply enact the President's budget, you will reduce the deficit, and you will get it down to practically nothing in 1993. This year alone, you will get it to 2.6 percent of GNP.

Senator **Conrad**. If you would just yield on that point, Mr. Secretary.

Secretary **Baker**. Surely.

Senator **Conrad**. If you look at the operating deficit, on the operating deficit side, and don't include the social security surpluses we are making very little progress.

Secretary **Baker**. I grant you that if you look only at the operating side, the numbers are different. But it is more than passing strange to me that we would wait until 1988 to start talking about looking only at the operating budget.

You know, it was two decades ago, Senator, that Lyndon Johnson put us on the unified budget. I think it was the right thing to do, and I think we ought to stay on the unified budget so that we can avoid political games by moving things on and off.

But you know——

Senator **Conrad**. Well, don't we have a game here? The American people out there think that we are running surpluses in social security now in preparation for the time the baby boomers come, when the baby boomers come, all they are going to find is a bookkeeping entry.

Secretary **Baker**. I will tell you what the American people think, in my view. They think that the taxes that this government has levied on them in the past are real—whether they are employment taxes or whether they are income taxes. They must pay them. Even though these revenues go into the various trust funds, they hurt just like income taxes. I don't think the American people resent the fact that we count them as taxes.

The unified budget approach enables us to take an overall look at the full range of assets and liabilities in the United States, and I think it is perfectly appropriate.

Why haven't we heard any suggestions before this year that we ought to somehow take the trust funds out of the unified budget?

Senator CONRAD. Oh, I think we have heard that. What has happened now is it becomes more and more misleading to us in terms of what we are doing with our budget. People across the country think that when we say we have a trust fund that we really do have a trust fund. It is a misplaced trust, unfortunately, because the money is not there.

Secretary BAKER. Well, then, somebody made a big mistake back in the early sixties when they created the unified budget. You are suggesting that, I guess? I don't think they did. And I think we ought to stay on the unified budget so that you and we get a look at the overall——

Chairman CHILES. For accounting purposes, I think that is true.

Secretary BAKER [continuing]. At the overall income and expenditures of the U.S. Government, at the overall tax burden on the American taxpayer, at the overall amount that we are spending, whether it is for trust fund purposes or other purposes. I think it is quite appropriate to have a unified budget.

Senator CONRAD. Well, you know, it wouldn't be a problem to have a unified budget if we were dealing with the deficit. We are not; you haven't. We have had 8 years of not dealing with it at all. It has just exploded on us. You have got an economic game plan here that is not sustainable.

Secretary BAKER. I think that $150 billion of deficit reduction over 3 years is dealing with the deficit. The chairman was a member of the budget summit agreement. Some of us, including him, would have liked to have been able to go a little bit further. But we could not do it. And we could not do it not just because of 1600 Pennsylvania Ave. We could not do it because of some very genuine, tough concerns in Congress as well.

Senator CONRAD. Well, Mr. Secretary, we don't have $150 billion of deficit reduction over 3 years. In the 3 years of the plan that is before us, there is no year-to-year deficit reduction.

Secretary BAKER. I am talking about 1987, Senator Conrad, and 1988 and 1989.

Senator CONRAD. I know. You are taking the $76 billion. But the $76 billion is not off of what the deficit was the previous year; it is off of a projection of what it was going to be 2 years from now. That is not real deficit reduction, Mr. Secretary, and that just misleads the American public, frankly.

Secretary BAKER. I think the chairman would agree with me that most of what we accomplished in the budget summit agreement was real. I would acknowledge that there is about $10 billion in there that is blue smoke and mirrors, but I think the rest of it is real. We surely fought, bled and died to get it over a period of a month.

Chairman CHILES. Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

Mr. Secretary, what comments would you like to make today on the Third World debt situation, your assessment?

Secretary BAKER. I would like to say, Senator Wirth, that I think that the only approach that offers any promise whatsoever if we are going to handle the Third World debt problem on the private side, as opposed to putting it on the backs of the taxpayers in the creditor countries, is the debt approach that we have been following over the course of the past 4 or 5 years.

I think we are making progress. I think the principles that underlie the debt strategy are every bit as valid today as they were then. Basically, the principles are that you are not going to solve this problem unless you find a way to increase growth in these countries; that increasing growth is going to require that these countries adopt free market economic policies, and that adjustment is going to require some capital flows by way of debt or equity to support that growth.

I think we are making good progress when you see a country like Brazil that announced and pursued a debt moratorium for a period of time, by its own statement say this was the wrong thing to do. Brazil was hurt by this approach. They have now paid interest for January and February. They are close to reaching an agreement with their bank creditors on a new package for 1988. I think we are making good progress on the debt strategy, and I think that notwithstanding what some say was a rather disappointing—and I do not agree with this characterization—result from the Mexican bond offer.

Senator Wirth. I was going to ask you about that. That was characterized in a lot of the financial press as being a disappointing offering. What is your reaction to that?

Secretary Baker. Well, let me say a couple things about that. Number one, that was never proposed as an overall global solution to the debt strategy. It was never suggested that it would be. I think that what has been accomplished there validates the fact that this is yet another item on the menu of items that can be used, along with a whole lot of other things—debt equity swap, voluntary interest capitalization, among others—to work on the debt problem.

It was a voluntary approach. It was a market-oriented approach. It gives the debtor country and the creditor countries and banks a better idea of the true market discount on that debt. And I for one would not be so quick to condemn it as a failure. I think at the very least it will serve as an additional menu item that we can utilize in the future, and at the very least it will serve as an exit bond for a number of banks that want to opt out of future packages.

Senator Wirth. What is the difference between what Morgan's was doing in the Mexican debt equity swap and what Drexel Burnham has been proposing to do in terms of the buying and selling of the debt?

Secretary Baker. I don't know what Drexel Burnham is proposing to do.

Senator Wirth. Okay. Well, then, you are not a good person to answer the question.

Secretary Baker. You are not talking about another specific debt proposal.

Senator Wirth. Well, there is another proposal out there, but let's leave that aside for the moment.

Secretary Baker. Drexel Burnham has not shared any international debt proposal with the Department of the Treasury.

Senator Wirth. Could you describe a little bit for us your thoughts on the so-called "debt for nature" swaps that have been going on? It seems to me you have taken, at least from my perspective, an extremely enlightened position in that arena, and that is very welcome. Could you give us a few words on how that works and what the further potential of that might be?

Secretary **Baker**. We have supported these arrangements. We had meetings a year or so ago with representatives of the World Wildlife Fund and others, and we do support the concept of "debt for nature" swaps on a voluntary basis, again, a market-oriented, voluntary transaction. And let me just interject here to say that anybody can solve the Third World debt problem if they are willing to put it on the taxpayer. If we had the money, a Marshall Plan to solve the Third World debt problem would be a great idea. But we do not have the money. We have to look to solutions on the private side.

These swaps are consistent with this approach. It is a private sector solution. It involves, as you know, banks either selling at a significant discount or donating Third World debt to a conservation organization, which then negotiates an agreement with the debtor nation for a conservation reserve—a forest in Bolivia, for instance. The debtor nation receives a significant discount on a portion of its external debt; the conservation organization gets a good conservation project; and the bank gets rid of some of its debt.

Senator **Wirth**. Does the bank write off a good deal of that debt; is that what happens?

Secretary **Baker**. Yes.

Senator **Wirth**. Doesn't that, though, eventually end up on the taxpayer? If the bank is writing that off, isn't that taxes foregone to the Treasury, in effect ending up in part on the back of the taxpayer?

Secretary **Baker**. To that limited extent, that is correct, yes.

Senator **Wirth**. So to say that none of this is being written off on the back of the taxpayer is not quite fair. What we are really doing is picking and choosing, and it seems to me there is where we want to be careful about this, and that there are certain public policy goals that we might want to pursue in terms of allowing banks to write off the debt. We might say it is a good thing to allow the write-off of that debt for the purchase of rain forests and the maintenance of certain environmental quality, but we might not want to allow that to happen in terms of trading off the sale of railroads in Bolivia or mines in Bolivia.

Secretary **Baker**. Well, we might not want to let it happen in the context of creating a great, big multilateral facility to be funded by creditor country taxpayers, to purchase the debt and somehow make the discount available to——

Senator **Wirth**. Well, that was just the final question. There are some very difficult public policy questions here. I mean, we agree to do certain things. We agree that as a government, we want to pursue the maintenance of rain forests, but we might not want to pursue other things; isn't that correct?

Secretary **Baker**. This is the only one I am aware of, Senator Wirth. The point you make, I think, is valid.

Senator **Wirth**. But people might be picking up and selling off, doing the same kind of a debt write-off and buying and selling other equity that is different from a rain forest; isn't that right?

Secretary **Baker**. They might, but they would not be getting a tax deduction for it.

Senator **Wirth**. Well, why wouldn't the bank be able to write off its debt in the same way, as they are—the bank writes off its debt, gives that written off instrument to, say, the World Wildlife Fund, and that in turn goes in and purchases that particular wildlife preserve.

Secretary **Baker**. Right, yes. I am not following, though, the example that you are making in the other area.

Senator **Wirth**. Well, could it be done in another way—say the bank writes off the debt and sells that debt to "x" brokerage company that goes in and buys a railroad, or goes in and buys a mining company, or goes in and buys a distribution company in that country. Why couldn't——

Secretary **Baker**. Well, I suppose so. If the deal between the bank and the brokerage company was an arm's-length deal, they could take a loss deduction. If they qualify for the loss deduction, I suppose that is correct. But that is true with respect to any indebtedness, whether it is Third World debt or anything else.

Senator **Wirth**. Well, it seems to me that this has the potential of, if we are doing it in the environmental area, it has the potential of being done elsewhere, and there are some significant public policy—I realize my time has expired, Mr. Chairman——

Chairman **Chiles**. Well, I think one depends on whether it is fostered with U.S. approval, is it not? If it is an already-accepted practice, we are not worried about it. If we are talking about something extraordinary that we are allowing some approval of, are we not?

Senator **Wirth**. Maybe we are. There are certain goals that we are approving and certain ones maybe we are not approving.

Secretary **Baker**. Well, I guess the distinction might be that what I am saying about private sector solutions versus public sector solutions is that we should not look to the Federal taxpayer for new appropriations, new money, and so forth, to bail out banks. That is not something we support.

Now, all banks have, as a matter of course, the right, as I understand it, to deduct losses on their claims as an ordinary, necessary business expense for banks. That has been their right, and that is going to continue to be their right. So, any time a bank sells some of that paper in an arm's-length transaction and takes a loss, I guess they can deduct that loss from taxable income. I am not enough of a tax lawyer to answer that, so let me back up.

Senator **Wirth**. You are a good Texas attorney, I heard earlier, though.

Secretary **Baker**. Not a tax attorney.

Senator **Wirth**. Finally, have you seen the Institute for International Debt and Development idea? Is that what you were referring to before in terms of creating a new instrument, this proposal?

Secretary **Baker**. Yes.

Senator **Wirth**. Have you all reacted to that publicly?

Secretary **Baker**. Yes. We don't think that it has much merit. It puts the solution, Senator, squarely on the backs of taxpayers in the creditor countries. They would have to fund the facility in the initial instance.

We think it could be counterproductive from the standpoint of encouraging countries to repudiate their debt, because that would increase the size of the discount that would be made available to them under the proposal.

Frankly, we really believe you must look at this problem on a case-by-case basis; the situation with respect to each country is different. The idea that somehow, there is some magic bullet or global solution to the debt problem is a distinct mirage, as far as we are concerned.

Senator **WIRTH**. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman **CHILES**. Mr. Secretary, we are delighted to have your appearance here and again compliment you on the work you are doing.

I noticed that two or three times in your statement, you said if we simply passed the President's budget, we would be at balance in 1993.

Secretary **BAKER**. Close to it.

Chairman **CHILES**. Well, I just want to say that since I have been here, we have been "going to be at balance" 5 years hence from 1971 when I was here, in 1972, and I will be leaving this year, and I don't believe 1993 ever gets here.

Secretary **BAKER**. That is because we have never passed the President's budget, Mr. Chairman.

Chairman **CHILES**. Well, but that is a little bit like brother Kemp saying that supply side economics works, if we'd just had a bigger tax cut, and if we had gone to the gold standard—and if we had done those things, he would have thought up two or three other things that we ought to do, too.

But we thank you very much for your appearance.

Secretary **BAKER**. Thank you, sir.

[Whereupon, at 11:45 a.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR DOMENICI TO SECRETARY BAKER AND THE RESPONSES

Farm Credit--Federal Financial Assistance

The 1987 Farm Credit Act calls for up to $4 billion in bond issuance in order to restore the financial health of the Farm Credit System (FCS). As a part of the financial assistance process, the federal government will pay an interest subsidy for the first five years of the bond issuance. The President's FY 1989 budget requests $175 million for the first year of the five year period.

1. QUESTION: Is it your view that this amount of money should be treated as mandatory or discretionary spending? Why?

ANSWER: This is mandatory spending. Once a government guaranteed bond is issued the interest payments are a legal obligation of the U.S. Government.

2. QUESTION: Assuming Congress treats the financial assistance as discretionary spending, do you as one who negotiated the so-called summit agreement, believe it should fall under the agreed upon discretionary spending cap for FY 1989?

ANSWER: Since payment of interest on these bonds is a mandatory expenditure, it would not fall under the agreed upon discretionary spending cap.

3. QUESTION: Should the amount of bonds approved by the so-called Assistance board be predicated on the need for financial assistance of System institutions or should the amount of bonds issued be predicated on Congressionally appropriated funds? Do you believe it is likely that delays in Congressional appropriations could cause an erosion of investor confidence in these or other federally guaranteed securities?

ANSWER: The amount of bonds approved by the Assistance Board should depend on the needs of qualified Farm Credit System institutions for financial assistance, as determined by the Assistance Board. If the amount of assistance is predicated on the amount appropriated to cover interest payments on the bonds, the Assistance Board may not be able to provide funds to institutions qualified for assistance. If they do not receive assistance, these institutions may not be able to extend loans to farmers and/or may default on their bond obligations, which would defeat the purpose of the Agricultural Credit Act of 1987.

If the Treasury does not have the funds to pay the interest due on these government guaranteed bonds on a timely basis, foreign and domestic investors would most certainly lose confidence in the Government's willingness and ability to meet any of its obligations.

4. QUESTION: The 1987 Farm Credit Act calls for both cash and non-cash assistance for the FCS. In your opinion which kind of assistance will be provided? Why?

ANSWER: We expect to provide both cash and non-cash assistance to qualified Farm Credit System institutions depending on the needs of each institution. For example, cash may be appropriate if the assistance is needed to redeem the stock of farmer borrowers who have paid back their loans. However, if non-cash assistance will satisfy the needs of an institution, the Assistance Board may choose this as the least cost form of assistance.

WINDFALL PROFIT TAX

QUESTION: Does the Administration support the repeal of the Windfall Profit Tax?

ANSWER: Yes. The Administration fully supports efforts to repeal the Windfall Profit Tax.

QUESTION: What oil price assumptions were used for FY 1988 and FY 1989 in the preparation of the budget and when were they developed?

ANSWER: The oil price assumptions were developed in the fall of 1987. The oil price assumption for FY 1988 was $18.77 per barrel and for FY 1989 was $19.51 per barrel.

QUESTION: Is it correct that, under those old oil price assumptions, you show a minimal loss of receipts from the repeal in FY 1988?

ANSWER: Yes. Under the old oil price assumptions, repeal of the Windfall Profit Tax was estimated to cost $12 million in FY 1988.

QUESTION: What was the prevailing oil price at the time the assumptions were made?

ANSWER: The prevailing oil price was about $18.00 per barrel at the time the assumptions were made.

QUESTION: How do these old oil price assumptions compare with current prices?

ANSWER: The current price of oil is substantially lower than the old price assumptions. The current price is about $15.00 per barrel.

QUESTION: Under current oil price projections, would you estimate any revenue loss from the repeal of the Windfall Profit Tax?

ANSWER: No. Under current oil price projections, repeal of the Windfall Profit Tax will cause no loss in Federal tax revenue.

TAX EXEMPT STATUS OF MUNICIPAL BONDS ISSUED TO FINANCE THE CONSTRUCTION OF WASTEWATER FACILITIES

QUESTION: The EPA's decision to use a letter of credit rather than cash grants to capitalize the water pollution control State Revolving Fund programs achieves the dual goals of spurring state financial independence in wastewater facility construction and easing the federal government's outlay burden. There is speculation, however, that the IRS may rule that the SRFs, solely because the federal government is using a letter of credit, will act as a federal guarantee of municipal bonds used to finance wastewater facilities. This ruling could endanger the tax exempt status of these bonds, clearly thwarting the intent of the 1987 Clean Water Act amendments. Such a ruling would pressure Congress to force EPA to use a cash grant approach, causing a significant increase in the federal outlay burden. Could you look into this issue, consult with EPA, and inform the committee as to your findings?

ANSWER: To ease the federal government's outlay burden in connection with the SRF program, the EPA has decided to delay payment of grants through a letter of credit procedure. As we understand it, under this procedure, states will draw down grants in accordance with a prescribed schedule rather than all at once. The last draw down will occur no later than eight quarters after the award of the grant. Because of the delayed payment schedule, the EPA has provided that draw downs pursuant to the letter of credit may be accelerated in certain cases (for example, when the state receives a request for a cash distribution from a recipient for payment of costs incurred for construction, or when a debt service payment on tax-exempt bonds issued by the State to fund an SRF is due (if other funds are not then available for such payment)).

Section 149(b) of the Internal Revenue Code provides generally that Federally guaranteed bonds are not eligible for tax exemption. We believe there is a significant argument that EPA's grant payment procedure does not involve a federal guarantee for purposes of section 149(b) merely because the delayed grant payment schedule may be accelerated (in the event of an insufficiency of funds to pay debt service, as well as in other events). We have requested the IRS to consider this specific issue. We will work with them to resolve it on a timely basis.

STRUCTURAL ADJUSTMENTS

Your testimony points up the fact that we are farther along in making the necessary structural adjustments both to bring interest rates down and to promote economic growth. For example, consumption is down, so personal savings should rise. The government deficit is down, so government dissaving should fall. The trade deficit is coming down -- this is a drain on total savings but should help the dollar and interest rates. And residential investment is down, which should provide some room for business investment to increase.

QUESTION 1: Do you agree that we are moving along the path of structural adjustments we need?

ANSWER: Yes, we are making progress in the direction of greater domestic saving and less reliance on capital from abroad. Our leading trading partners are also making some progress toward correcting structural imbalances. This will permit a steady correction of international imbalances.

- After drifting downward to the 3 percent range in the middle of last year, the rate of saving of U.S. households rose sharply in the fourth quarter of last year and remained high early in 1988. Analysts generally agree with the Administration forecast of some additional improvement in the personal saving rate this year.

- The Federal deficit (dissaving) declined by a record $71 billion last year, and if our budget proposals are followed will decline about 1/2 percentage point as a share of GNP over each of the next five years.

- Our trade deficit has narrowed substantially in real terms, and that has resulted in a resurgence of the industrial sector of the economy and rising employment in manufacturing. The lower dollar resulted in rising import prices sufficient to offset improvement in real trade volumes, however, and there was a modest further deterioration in the nominal trade balance until the fourth quarter of last year, when a modest improvement in the nominal balance appears to signal a turnaround. Private analysts, along with the Administration, are expecting a marked improvement during the course of 1988.

QUESTION 2: Would you say that we may be in the midst of a capital spending boom?

ANSWER: Business capital spending is expected to grow at a healthy, sustainable rate in 1988. As a share of real GNP, business fixed investment reached a postwar record of 12.6 percent in 1985, which might well qualify as a "boom." Capital investment edged down in 1986 in real terms and failed to match growth of real GNP last year. For 1988, the latest Commerce Department survey of capital spending plans point to an increase in outlays for plant and equipment of 7.3 percent, with greatest strength in the manufacturing sector where improvements in our competitive position in tradable goods and rising rates of utilization provide inducements for increased capital spending.

QUESTION 3: Won't this help inflation and ultimately interest rates?

ANSWER: A high rate of capital formation should translate into improved rates of productivity growth, which, in turn, will help dampen inflation. Lower rates of inflation would imply correspondingly lower interest rates. Further, if we are to make continued progress in reducing imbalances in our international account, the capacity of our manufacturing industries must expand significantly, or else we will eventually bump against capacity constraints, which could generate inflationary pressures.

WHY ARE REAL INTEREST RATES SO HIGH?

QUESTION: When Chairman Volcker took charge of monetary policy, inflation was accelerating out of control. We committed ourselves to a period of high real interest rates to bring inflation down. Now inflation is down. But real interest rates are still high.

ANSWER: Real interest rates are impossible to measure precisely, as they represent the difference between actual interest rates and the expected rate of inflation over the life of the instrument, which is never known with surety. As commonly measured, real rates were high early in this decade, after being negative through much of the 1970's. More recently, they have come down significantly, though public perception has not fully caught up with that reality.

- As an example, the rate on 3-month Treasury bills of about 5.7 percent recently minus the latest 12-month change in the consumer price index yields an estimated real rate of 1.7 percent, which was the average for the decade of the 1960's.

- A recent Richard Hoey (Drexel Burnham Lambert) survey of financial market decision makers indicates that expectations of inflation over the next 10 years are 5.3 percent. Subtracting that figure from recent yields on 10-year Treasury bonds of about 8-1/4 percent yields a real rate of about 3 percent, compared with an average during the 1960's probably of roughly 2-3/4 percent.

- Real interest rates, of course, depend on expected rates of return on invested capital, as well as on Federal Reserve policy and other forces. Early in this decade, reductions in marginal tax rates, a lower rate of inflation (which, combined with historic cost accounting, erodes rates of return), and less interference on the working of the economic system combined to boost expected rates of return. More recently, the lower dollar has enhanced the competitive position of U.S. industry, and that has undoubtedly affected expected rates of return.

QUESTION: Is there a problem with "crowding-out"? Chairman Greenspan indicated that foreign capital has made the notion of crowding out obsolete.

ANSWER: Early in this decade, a number of economists wrongly predicted that increasing budget deficits in this country would push up interest rates and crowd out private investment. As it turned out, higher rates of return on investments in this country led to a capital inflow that supported a high rate of capital spending. However, we should not count on foreigners to increase indefinitely their holdings of dollar denominated assets. Rather, we should take steps to increase domestic savings, including reducing the Federal deficit from the spending side, which would have a much greater impact on saving than tax rate increases.

QUESTION: Are import prices a problem? Chairman Greenspan indicated that import prices did not pose a great risk.

ANSWER: The decline in the dollar since early 1985 has meant increases in import prices, and these have put some moderate upward upward pressure on U.S. price levels. During the course of 1987, nonfuel import prices rose by 9.6 percent, or more than double the rate of increase for the nonenergy component of the consumer price index. However, this is a one-time adjustment. If we follow prudent economic policies, there is no reason for the rise in import prices to become permanently entrenched into the wage-price structure, or into inflation expectations and thence into interest rates.

QUESTION: What about wages and costs? Wages have grown at 2.5 percent for the past two years. Costs have grown by less than 2 percent.

ANSWER: Growth of wage rates has been quite moderate during the current expansion. During the four quarters of 1987, total compensation per workhour (wages and salaries plus fringe benefits) increased by 2.8 percent in the nonfarm business sector, off from 3.4 percent in the prior year. With productivity rising, unit labor costs were up only 1.2 percent last year and by just 1.9 percent during the four quarters of 1986. Clearly, labor costs have been an important factor moderating inflation and inflationary expectations.

QUESTION: What about the budget deficit? Your own testimony indicates substantial progress. I understand that Treasury borrowing requirements over the first half of 1988 will be the lowest they have been since 1980.

ANSWER: Very substantial progress has been made in reducing the budget deficit. It fell by $71 billion in FY-1987, which is equivalent to 1.9 percent of GNP. Enactment of the Administration budget would mean that publicly held debt would be growing no faster than GNP this year and would increase by substantially less than GNP in the years thereafter. Thus, the deficit would be a decreasing drain on the savings pool.

QUESTION: The dollar is strengthening. Doesn't that provide some flexibility for interest rates to come down.

ANSWER: The dollar has firmed a bit so far this year, even in the face of a slight narrowing of spreads between interest rates here and those of some of our leading trading partners. This is gratifying and apparently indicates that global financial markets are becoming increasingly aware of our progress in reducing the trade deficit and in bringing Federal borrowing under control.

QUESTION: Would you not expect interest rates to begin to come down?

ANSWER: The Administration economic forecast contains further declines in interest rates this year and in the years ahead. That forecast incorporates some further reduction in real rates, but more importantly reflects our view inflation can gradually be wound down if the appropriate economic policies are pursued.

QUESTION: I understand the Japanese plan to tax a huge pool of savings which has previously been tax-exempt. These funds are principally MARUYU bonds and postal savings accounts. Do you think some of these funds will find their way into the international market place? Will they depress interest rates?

ANSWER: The tax-exempt savings were held by small individual investors (although the cumulative total is large) who are likely to want to keep funds in yen assets. These deposits are currently held with institutions that are authorized to acquire assets abroad. If there is a shift of deposits into other instruments, it could affect the percentage of funds flowing out of Japan, but it is unlikely to be significant enough to affect interest rates.

QUESTION: Finally, it is remarkable that real rates have remained virtually unchanged since the Summit process took over the control of exchange rates. With all of the positives on inflation, the progress we are making on world imbalances, and possible new pools of savings, can the G-7 now coordinate to bring interest rates down?

ANSWER: While calculations of real interest rates are difficult to make with confidence (since inflation expectations must be estimated), most calculations show G-7 real interest rates lower now than in 1985. Despite some increases since early 1987, as a broad generalization nominal interest rates have remained below the averages for most years of the decade and closer to late 1970's rates. The exchange rate stability and low inflation that the coordination process furthers can lead to lower real and nominal interest rates.

Global Debt Solution: The American Express Plan

Question: Mr. Secretary, have you had a chance to review the debt proposal made Monday night by the President of American Express? If so, I would appreciate your assessment of it, based on the criteria laid out on page 8 of your testimony:

-- Would it have major cost to the taxpayer?
-- Would it discourage new private money flows?
-- Would it politicize the problem more than it already is?
-- Most importantly for us, would it promote long-term growth and restore export markets for American goods and services?

Answer: We have looked into this and similar proposals and cannot endorse the establishment of an international debt facility.

Such a facility would involve a major transfer of risk on outstanding commercial bank loans from the private to the public sector. Mr. Robinson's proposal calls for wholesale securitization of commerical bank debt, and would require creditor countries to guarantee interest on these securities. Paid-in or callable capital could amount to $12.5 billion, with creditor governments liable for additional amounts if debt is not serviced. Commercial bank losses on transfers of debt to the facility would also be tax deductible.

Banks absorbing losses on the existing loan portfolio would be reluctant to provide new loans. Any new loans that are provided, including short-term trade credits, would flow through the facility. This would represent a major step away from the return to voluntary lending and creditworthiness that we have sought. Private investment would also likely suffer.

Furthermore, while the facility is being negotiated, expectations of debt forgiveness could undermine both new lending and debtor reform programs, further politicizing the adjustment process. Debtor nations would seek equal treatment regarding debt relief and debt forgiveness under the facility, making it difficult to differentiate based on performance.

The key to sustained economic growth in debtor nations is market-oriented economic reforms. Such policy changes will provide a firm basis for stronger, sustained growth in these countries and will increase markets for U.S. exports.

RELATIVE U.S. ECONOMIC STRENGTH

QUESTION: There is much talk around about the relative standing of the United States in the world. On Tuesday, we heard from Paul Kennedy, the author of the book The Rise and Fall of the Great Empires. Now, the "decline" of America seems to be a hot topic these days. But, I must say, looking at the data, I find the notion that we are doing relatively worse than our trading partners -- with the possible exception of Japan -- hard to support. Even Japan, with its great financial resources has enormous problems.

(1) Can you comment on this issue? What is your view of the relative economic power of the U.S. in the world?

(2) Isn't there some evidence that the relative economic power of the United States has increased during the 1980's, after a decade of decline during the 1970's?

(3) Would not some interpret the ability of the United States to negotiate and enforce agreements realigning the currencies of the industrial world to its advantage, as a sign of economic power rather than weakness?

ANSWER: The United States remains the world's most important economic power. Our share of world GNP has grown since 1980, and instead of double digit inflation and interest rates we have moved into a period of sustained growth with low inflation. The current expansion, now in its 64th month, is the longest peacetime expansion on record, with GNP growth averaging 4.2 percent per year. We have created over 14-1/2 million jobs since 1982, more jobs than Western Europe and Japan together have in the last decade.

While much has been achieved, there are still problems that must be overcome, particularly the budget and trade deficits. The budget deficit is coming down, and in fiscal 1988 will be 3.1 percent of GNP, below the Summit country average. We also expect a significant reduction in our trade deficit this year. Recognizing that we live in an interdependent world, the Administration has led the major industrial countries in intensifying efforts to strengthen international economic policy coordination. The key focus of these efforts has been to achieve reductions in external imbalances in the context of sustainable noninflationary growth and greater exchange market stability. We are making substantial progress in achieving these goals.

Senator Domenici

MORE JAPANESE MONEY FOR WORLD MARKETS?

Question: Beginning on April 1st of this year, the Japanese government plans to tax various forms of government finance that have been previously tax-exempt. These include the Japanese postal savings accounts and certain securities called MARUYU bonds. Given the new tax on these accounts and the very low interest rates they receive, would you not expect these funds to find their way into the international market place -- possibly through Japanese mutual funds or other competitive securities?

Answer: Individual Maruyu investors are unlikely to directly invest overseas. Affected savings are small individual accounts (although cumulative total is large) and most depositors would probably want to keep funds in yen assets. The accounts are currently with the Ministry of Finance Trust Fund and the Post Office. These financial institutions are already authorized to acquire certain assets abroad. The key variable would be the relative propensity of other financial institutions that small savers might prefer to invest abroad.

Question: Given the size of these funds, would not even the gradual release of these savings into the international market place make interest rates go down?

Answer: It is not even clear that there will be a sizeable shift out of Maruyu accounts after the new tax takes effect in April. If there is a shift of deposits into other instruments, it could affect the percentage flowing out of Japan, but it is unlikely to be significant and therefore unlikely to have any effect on interest rates in the international market place.

IRS COMPLIANCE REVENUES

QUESTION: The President's budget indicates that IRS compliance measures will raise $2.4 billion in new revenues in FY 1988. Why does this estimate differ from that agreed upon in the summit agreement?

ANSWER: After reviewing the levels of additional funding passed in the Continuing Resolution for FY 1988 minor revisions were made to the totals, involving a slightly higher level of compliance receipts in the first year and a different timing of collections over the FY 1988 and FY 1989 period. The Administration's estimate of the effects of the Continuing Resolution cumulate to almost the same net two-year total as included in the Summit Agreement (see table below).

QUESTION: What is your understanding of the summit agreement regarding IRS compliance revenue in FY 1989? Did the summit agreement specify that the FY 1989 revenues would result from the FY 1988 appropriation level?

ANSWER: The summit agreement was for net compliance revenues of $2.9 billion from the IRS initiatives initially funded in FY 1988. The agreement did not specify that these revenues would result from the FY 1988 appropriation level; however the totals used in the agreement were estimates based on an assumed continuation of FY 1988 funding levels in FY 1989.

QUESTION: What is the estimate in the Presidents's budget for the FY 1989 effects of IRS compliance? How was this estimate arrived at? Why is it different from the summit agreement?

ANSWER: The Administration's estimates for the FY 1989 effects of IRS compliance are shown in the table below. The estimates are arrived at after review of IRS analyses and models used to determine resource allocation within the Service. Yields under different allocations of enforcement resources are generated and reviewed for consistency with the overall budget receipts forecast. The final model results are the basis for forecasting the impact of additional enforcement resources appropriated to IRS in both FY 1988 and FY 1989. This review resulted in slightly lower level of compliance receipts in FY 1989 than originally anticipated. However, as noted above, the total over the two-year summit agreement period is almost the same (in fact, slightly higher).

Background:

Estimates of Compliance

(Fiscal Years)

Revenues	1988	1989	Total,1988 and 1989
	($ Billions)		
Gross Receipts:			
Summit Agreement 1/	2.0	3.3	5.3
FY 1989 Budget	2.4	3.1	5.5
Net Receipts:			
Summit Agreement	1.6	2.9	4.5
FY 1989 Budget	2.0	2.7	4.7

1/ Not explicitly shown in the Agreement.

VIEWS OF THE FEDERAL RESERVE SYSTEM

WEDNESDAY, MARCH 2, 1988

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Hollings, Sasser, Fowler, Conrad, Domenici, Symms, Grassley, and Nickles.

Staff Present: Richard N. Brandon, staff director; and John Hilley, assistant director, macro-ecomonics, trade and finance.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Good morning, Dr. Greenspan. We welcome you to the Senate Budget Committee. You have appeared before us many, many times over the years. This is our first opportunity to welcome you as Chairman of the Fed, and we certainly do welcome you on that basis.

A little over 200 days ago, you became chairman of the Board of Governors. It has been quite a time.

You have had to ride the giant slalom with the stock market and the dollar. At the same time, you have had to try to steer a winning course between inflation and recession.

We know that it has not been easy, especially with an obstacle on the course as large as the Federal deficit. But you have done a good job under tough conditions.

Our trade picture has improved with a sharp up-turn in exports, and we all hope it is the beginning of a trend. We need some time for stability to return to the currency and financial markets.

Still, the conventional wisdom these days is that the next President and the next Congress are in for some agonizing times. The national debt has ballooned, and it is getting bigger all the time, along with our interest payments.

The Federal deficit is substantial, and we continue to borrow money to pay the freight.

I, for one, am more concerned than ever about the ongoing redistribution of wealth in this country. The rich seem to be absorbing more of the wealth produced by the great body of wage earners in the middle-income category.

We are at a point where those who lend, as well as those who borrow, are over-extended, and middle-income Americans are squeezed from foreign competition and by the demise of the good-paying manufacturing jobs.

My guess is that if there is one thing that would make your job easier, it would be a sharp cut in the Federal deficit. We know how hard it was to work out a 2-year, $76 billion package last year. The choices ahead are going to be even harder next year.

We are certainly going to need your help this year to help sustain the economic expansion. But it should be clear to all of us by now that without basic, structural improvements in our borrowing habits, the Federal Reserve cannot do it all forever.

The times are very complex. We have the haunting feeling that conditions are still fragile. In some ways, we are like that patient that has had the heart attack; he is in the convalescent period hoping that there is not going to be a reoccurrence after what we saw with the stock market.

The one thing that we can be sure of is that we are approaching a time of major choice in our affairs. We have got to find a way to make additional spending cuts at the same time we are making important investments in the future.

We certainly welcome you, Dr. Greenspan, and your views today about what needs to be done in the months ahead to deal with our deficits both at home and abroad.

We are glad you could be with us, and we certainly look forward to your testimony.

Senator Domenici.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Mr. Chairman, thank you very much.

Chairman Greenspan, I too welcome you, and going back over the record I note that you have appeared before this committee more times and in more different capacities in your public career than any other individual in the history of the Budget Committee. So today we welcome you in yet a new capacity as chairman of the Federal Reserve Board.

I have reviewed your testimony in a cursory manner. I am going to say a few things about interest rates. I hope that my comments will be taken in the same light that I will take your admonition to us in your testimony as to what we ought to be doing in Congress.

You have a very lengthy litany of what you assume we ought to do in areas of fiscal policy. I hope you do not think I have changed my attitude regarding the Fed's independence and how important it is to stability in this country, because I truly believe that to be very important. I have read the book that allegedly talks about the secret army called the Federal Reserve that runs everything, but I have not changed my mind.

But since you have told us what we ought to do, I would just like to share a concern I have about monetary policy right now.

Your predecessor used some language before us–incidentally, he did not use to tell us what to do as much as you are in your statement. He just talked about inflation mostly. He called inflation the "Northwest Passage" that we had to get through. And Mr. Volcker kept telling us we had to get through that Northwest Passage of high inflation and inflation expectation. We use to ask him what measures he looked at to measuure inflation expectations. Of course, he would mention a few, but labor costs and increases in the major labor contracts were very important. And inflation was very important.

I really know that you are getting pushed on all sides. I am suggesting you not be political either way. 1985 inflation was 3.2 percent; 1986 inflation was 2.6 percent; and 1987 inflation was 3 percent. Labor cost increases, using the index that is most accepted by economists: 1985, 3.1 percent; 1986, 2.5 percent; 1987, 2.8 percent.

Now, there are some who will say our reduction in inflation is accidental, unexpected, we did nothing to earn it. But it is real. It is there. And I do not see anyone predicting major increases in inflation.

Well, I look, then, to what has happened to real interest rates; that is, the percent that interest rates in the marketplace exceed inflation. And I regret to tell you that I do not understand. In 1983, it was 7.2 percent; in 1984, it was 8.7 percent; in 1985, it was 7.4 percent; and now it starts to come down. In 1986, it is 5.1 percent; and then it starts to go up. In 1987, it is 5.4 percent, and if I read the current number right, in 1988, it is 5.5 percent.

Frankly, I do not understand with those inflation rates, those labor costs, and in spite of poor performance up here, with a lot of hard work we have reduced the deficit by 1.9 percentage points to 3.4 percent of GNP. That is not a little bit. It is a lot.

Some would say it is temporary; some would say how are you going to fund defense at the levels you are at, and all these other things. But we have done it, a 1.9 percent of GNP reduction in the deficit. And I do not understand why real interest rates do not come down under those set of facts.

I am concerned, and I hope everyone understands, that yes, we have this big deficit to contend with. But it is the interest rates that determine what we have to pay for debt service. My rough calculations are that a 1 percent increase in the interest rates adds $11 to $12 billion to the deficit based on the current deficit that we have to fund.

We struggle to find $11, $12, $15 or $20 billion in cuts, reductions, and/or revenues; and, I repeat, 1 percent interest rate reduction equals $11 to $12 billion based on current levels of deficits. So while I accept your admonition to us regarding the deficit and your analysis of what we ought to be doing in entitlements and in other areas, I am somewhat confused as to why interest rates are not continuing on a downward path.

So I welcome you. I hope you will tell us today whether you have some new indexes you are looking at. We have to know what the previous chairman and commission was doing, what they were looking at. I am reading all kinds of new commodity relationships, and I am very interested in how you are looking at real interest rates and your responsibilities there.

Thank you, Mr. Chairman.

Chairman CHILES. Thank you, sir.

Dr. Greenspan.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Dr. GREENSPAN. Thank you very much, Mr. Chairman. I would like to excerpt from my prepared testimony and request that the full statement be placed in the record.

Chairman CHILES. Your full statement will be placed in the record.[1]

Dr. GREENSPAN. Mr. Chairman and members of the committee, I appreciate the opportunity to appear before this committee today as you begin your deliberations on the budget for fiscal year 1989. The Summit Agreement reached with the administration in November, if fully implemented, should maintain pressure on the deficit this year and next. But it is crucial that further actions in support of a long-term policy of reducing budget deficits and the associated claims on the Nation's supply of savings be taken.

As I reported to the Banking Committees last week, 1987 generally was a good year for the U.S. economy.

As we move into 1988, members of the Federal Reserve Board and the Reserve Bank Presidents look for a moderate rise in real GNP over the course of this year—on the order of 2 to 2½ percent. Inflation, meanwhile, is anticipated to fall within the range of 3¼ to 3¾ percent, similar to the 1987 pace. The "central tendency" of our projections for real GNP growth this year encompasses the administration forecast, but is somewhat stronger than that of the Congressional Budget Office. We also are a bit more optimistic on prospects for price inflation. However, the differences are not large.

In this context, the Federal Open Market Committee, at its meeting last month, set ranges of 4 to 8 percent for growth of M2 and M3 this year.

Looking beyond 1988, prospects for maintaining balanced growth, as well as continued improvement in our external accounts, will depend importantly on developments in the Federal budget.

In that regard, the importance of taking actions to make a sizable dent in the budget deficit during periods of satisfactory economic performance becomes even more apparent when we recognize the likely effects on revenues and outlays of a future economic slowdown, if one were to occur. While we all seek to avoid recessions, the Congress cannot count on indefinitely sustaining Federal revenues by a growing economy.

The achievement of meaningful deficit reduction undoubtedly will require that some hard decisions are made. The adoption of the Gramm-Rudman-Hollings approach, and its reaffirmation last year, highlight all too vividly the extraordinary difficulty of making such choices. There are no easy answers or magic formulas. Nonetheless, economic logic and historical experience can provide a framework for analyzing the range of possible options.

I suspect that in the long run there are upside limits to the share of income that can be taxed. For several decades, the overall Federal tax bite has been fairly flat, at a bit less than 20 percent of GNP, and under current tax laws will remain in this range into the 1990s. This stability over time is not a coincidence, but is indicative of the public's aversion to rising tax burdens. That sentiment was reflected in the many small tax changes in the 1970s, as inflation pushed many taxpayers into higher brackets, and in the large reductions that were enacted in the early 1980s.

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[1] See p. 246.

Of course, no one likes higher taxes, but I also sense a more sophisticated awareness of the disincentives and economic inefficiencies that seem to grow disproportionately along with the size of the tax burden. And people are skeptical that tax increases will translate fully into smaller deficits, given the reduced pressure to control spending that would result.

This does not mean, however, that revenue changes should be dismissed out of hand. Some specific taxes may serve other desirable objectives, while also bringing in needed revenues. For example, I have long urged the consideration of a sizable increase in the Federal gasoline tax. A hike of 15 cents per gallon, for example, could raise close to $15 billion in revenues, while retail gasoline prices still would be well below the levels of the early 1980's. And if energy use is restrained at all, there is a further benefit.

But on the whole, deficit reduction efforts must of necessity focus on the expenditure side of the budget. Over the past three decades, we have seen marked shifts in the composition of Federal spending, accompanied by a distinct upward trend in its ratio to nominal GNP. That ratio, which reached 24 percent of GNP in the mid-1980s, has edged off in the past few years, in part because the administration and the Congress have been relatively successful in holding the line on new programs.

I do not underestimate the difficulty of the task of further reducing the ratio of Federal outlays to GNP. Several rounds of deficit reduction efforts already have taken care of the "easy" cuts. Partly as a result, the composition of the budget has shifted toward those categories that are less amenable to control, at least in the short run. In particular, interest payments were nearly $140 billion last year and, in light of prospective deficits, are likely to grow even larger in coming years. The way to control these payments and to get a handle on the scale of Federal debt relative to GNP, is to concentrate on the remainder of Federal spending and on the so-called "primary deficit"—that is, the deficit excluding interest payments (net of taxes on interest).

Controlling the growth of outlays is crucial and will require close scrutiny of virtually all programs. Such control, in the face of demographic pressures, will demand a willingness to take bold, controversial actions. It is essential that this committee focus on those changes that will result in significant savings, not just this year or next, but on a lasting basis.

It would be inappropriate for me to offer suggestions on specific program actions to reduce the deficit. All the alternatives are known. The choices are political, not economic. But simple arithmetic points clearly to those areas where the scope for action is greatest. For example, entitlement programs offer substantial opportunities for long-term budgetary savings, since they currently account for nearly half of total outlays. And with the base of expenditures certain to expand in conjunction with the increase in the beneficiary population during the next few decades, the deficit reduction benefits of changes in the law today will accumulate over time, leading to much larger savings in the year 1995 and beyond than in, say, 1990 or 1991.

Leaving aside the serious questions of evaluating military adequacy, the budgetary arithmetic of cutting defense spending is considerably less favorable. In part, this is because the budget Summit Agreement already has solidified a recent trend toward reductions in appropriations from President Reagan's original overall defense plan. But more fundamentally, defense programs are essentially lumpy. A large share of spending in the early and mid-1980s went to build up our military asset base. But as we reach the requisite number of F-16 wings, air carrier groups, missile deployments and the like, expenditures will fall back toward maintenance levels which are significantly lower in real terms than the huge outlays of the past few years. Accordingly, reductions in defense procurement programs are not translatable, as they are in entitlement programs, into very much larger cuts in the future.

As for discretionary domestic spending, these programs are a small and shrinking share of the total, and many provide services that enjoy broad support. Moreover, in a number of areas such as law enforcement, environmental protection, and air traffic safety, there are few feasible alternatives to the Federal programs.

There are, however, areas where the private sector probably can provide services more efficiently, and at lower cost, than the government. The President's budget placed a high priority on "privatization" and suggested several activities that could be transferred out of the Federal sector. I believe this emphasis is appropriate and deserves careful consideration on its own merits. But I would stress that the resulting asset sales should not obscure the more fundamental budgetary issue. Indeed, I would be troubled by the extensive use of asset sales as a long-run deficit reduction strategy. Merely shifting the ownership of an asset from the government to the private sector has little effect on overall credit demands; moreover, it produces only a one-time budget saving.

I would also be disturbed by the greater use of Federal credit guarantees as a substitute for on-budget outlays. Such a substitution may lower the measured budget deficit, but it does not reduce the Federal presence in credit markets. Both the administration and CBO have long argued that current budgetary procedures give a misleading impression of Federal credit activity. In this regard, the administration's proposals for reform, which call for the explicit recognition and better measurement of the subsidy value of credit programs, point in the right direction.

A smaller public sector would carry significant benefits in terms of improved efficiency of the overall economy. The relationship between the size of the government and economic performance is complex and depends—among other things—on the mix of consumption and investment in government spending. Moreover, budget figures do not capture the full scope of governmental activities on real resource allocation; the effects of the government economic regulation on private activity may be sizable.

International comparisons inevitably are difficult, and the empirical evidence is only roughly suggestive of broad trends. But the disappointing macroeconomic performance of many industrialized nations over the past few decades, in the face of rapidly expanding public sectors, does raise questions about the true costs and benefits of large government expenditures. Indeed, in several European countries with sizable public outlays on income maintenance, education, and health care, those programs are coming under increased scrutiny, in part because of a perception that some of them have had detrimental effects on individual incentives and resource allocation.

To sum up, the benefits from taking credible actions to curb Federal outlays and related credit demands will be enormous. Over the longer run, lower deficits will absorb less of our private savings and, all else equal, allow private investment to flourish. Moreover, a clear demonstration to the financial markets that the current services budget has been set permanently on a more favorable track will have a handsome payoff currently in terms of lower real interest rates. As I stated earlier, one way to achieve that outcome is to exploit the "wedge effect" arising from reductions in programs such as entitlements, where the savings tend to grow over time. I should note too that, in my view, you run little risk of setting deficit reduction objectives that would be excessive in macroeconomic terms, given the broad constraints of political feasibility. And at some point in the future, it probably will be desirable to aim not just for smaller deficits, but for outright budgetary surpluses.

In closing, let me commend the Congress for initiating the National Economic Commission. The commissioners face an extremely difficult challenge, and I wish them well.

Thank you.

Chairman CHILES. Thank you, Dr. Greenspan.

[The prepared statement of Dr. Greenspan follows:]

Statement by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

March 2, 1988

I appreciate the opportunity to appear before this Committee today, as you begin your deliberations on the budget for fiscal year 1989. The Summit Agreement reached with the Administration in November, if fully implemented, should maintain pressure on the deficit this year and next. But it is crucial that further actions in support of a long-term policy of reducing budget deficits and the associated claims on the nation's supply of saving be implemented. This morning, after a brief review of the current economic situation, I would like to address some of these longer-run fiscal concerns.

As I reported to the Banking Committees last week, 1987 generally was a good year for the U.S. economy. Real GNP rose nearly 4 percent, almost twice the pace of the previous year, and unemployment continued to decline. In January of this year, the civilian jobless rate stood at 5.8 percent, nearly a percentage point below its year-ago level.

Especially encouraging was the improvement in the balance between domestic spending and domestic production. Although it is not yet evident in the nominal figures, there has been a marked turnaround in real net exports. Our international competitiveness has been enhanced by the success of business and labor in increasing productivity and restraining cost pressures. In addition, the lower level of the dollar on foreign exchange markets, because much of it was not passed through into wages and other costs domestically, also helped our firms price more competitively in foreign markets and compete with imports at home. As a result, exports have been soaring in real terms and the growth of imports has slowed.

This turnaround in the external sector also has contributed to better balance across domestic industries and regions of the country. In particular, output in the manufacturing sector has picked up appreciably, in response to both stronger orders from abroad and higher levels of capital spending at home. Improvement also was apparent among domestic energy producers and in agriculture, two sectors that had lagged considerably in recent years.

On the negative side, virtually all broad measures of price inflation rebounded somewhat, after dropping sharply in 1986. And, although wage increases remained restrained, we clearly need sustained effort to bring about price stability.

As we move into 1988, members of the Federal Reserve Board and the Reserve Bank Presidents look for a moderate rise in real GNP over the course of this year, on the order of 2 to 2-1/2 percent. The stock market plunge has added continued uncertainty to the outlook, and activity in the near term may be restrained somewhat by efforts to bring inventories into better balance with sales. However, such an inventory-induced slowdown almost surely would be reflected first in shortfalls in manufacturers' orders, and for the moment at least, order books remain impressively solid. In general, there are few signs of the imbalances that typify the late stages of a business cycle expansion. Moreover, the external sector is expected to provide considerable support to domestic production throughout the year. Inflation, meanwhile, is anticipated to fall within a range of 3-1/4 to 3-3/4 percent, similar to the 1987 pace. The "central tendency" of our projections for real GNP growth this year encompasses the Administration forecast, but is somewhat stronger than that of the Congressional Budget Office; we also are a bit more optimistic on prospects for price inflation. However, the differences are not large.

In this context, the Federal Open Market Committee, at its meeting last month, set ranges of 4 to 8 percent for growth of M2 and M3. Expansion of money within these ranges, whose midpoints are one percentage point lower than those of last year, is expected to support continued economic growth at a pace that is consistent with sustained external adjustment and progress over time toward price stability. Given the large movements of money relative to income in recent years and the unusual degree of uncertainty in the economic outlook, the FOMC widened the ranges for money growth to 4 percentage points and will continue to assess the behavior of the aggregates in light of information about the pace of business activity and the source and strength of price pressures, with particular attention to the performance of the dollar on foreign exchange markets and other indicators of the impact of monetary policy.

Looking beyond 1988, prospects for maintaining balanced growth, as well as continued improvement in our external accounts, will depend importantly on developments in the federal budget. It is encouraging that the latest figures from the Congressional Budget Office show the baseline deficit on a declining trend into the early 1990s, especially when you recall that, as recently as 1985, such projections approached $300 billion, or more than 5 percent of GNP. Nonetheless, the deficits as currently estimated remain sizable, as a share of GNP as well as in absolute terms. Moreover, relatively small changes in the assumptions underlying budget deficit projections can alter them quite radically, as recent history demonstrates.

Throughout most of the postwar period, gross private domestic saving and investment were roughly in balance, at slightly more than 15 percent of GNP. Budget deficits generally were small, at least by today's standards, and the U.S. showed a positive—and gradually increasing—net foreign investment position. In the 1980s, the pattern changed dramatically, as total domestic saving fell well below investment, reflecting not only the enormous federal deficits, but also a large drop in the private saving rate.

That gap between domestic saving and investment has been filled by capital inflows from abroad. This is neither a satisfactory nor a sustainable solution over the longer run. Indeed, an examination of the historical record reveals that it has been the exceptional industrialized country that has been able to attract large capital inflows on an extended basis in the past quarter-century. In this regard, the lesson for the United

States is clear. The widely anticipated improvement in the nation's current account balance will provide considerable benefits to the overall economy, but also will result in diminished capital inflows to the United States.

The record also shows that the relatively healthy share of gross investment in GNP in the 1980s has masked a perceptible decline in the investment share measured net of depreciation—that is, the portion of investment spending that actually increases the nation's capital stock, rather than merely replacing worn-out equipment and structures. This divergence reflects a continued shift in the composition of investment, away from long-lived assets such as structures toward high-technology and other shorter-lived equipment, which has raised the share of depreciation in gross investment.

Achieving adequate investment rates—whether measured in gross or net terms—is critical if we are to equip the nation's productive facilities with the state-of-the-art technology and machinery necessary to enhance our international competitiveness. This will require stepped-up domestic saving, in order to compensate for the anticipated slowing in capital inflows.

It is difficult to explain why saving by households and businesses has fallen to such low levels, and there is considerable uncertainty about the outlook for saving in coming years. Some arguments, such as the association between lower saving and the surging stock market of the mid-1980s, suggest that the low saving rate is a temporary aberration. But other factors that are believed by some analysts to have depressed private saving, such as a diminished need to save for emergencies because of improvements in disability and life insurance coverage and the easier financing of "big-ticket" items, are likely to persist. In any event, despite numerous initiatives, public policy has had little effect on private saving. Indeed, over the years, we have enacted significant tax changes designed to provide incentives to saving, but the evidence of most economic studies suggests that the net effect has been to shift saving from one pile to another, without much impact on the total. Thus, the surest way to overcome our shortage of aggregate domestic saving is through sizable reductions in budget deficits. Such steps are essential if we are to avoid greater pressures on financial and foreign exchange markets.

The importance of taking actions to make a sizable dent in the budget deficit during periods of satisfactory economic performance becomes even more apparent when we recognize the likely effects on revenues and outlays of a future economic slowdown, if one were to occur. While we all seek to avoid recessions, the Congress cannot count on indefinitely sustaining federal revenues by a growing economy.

The achievement of meaningful deficit reduction undoubtedly will require that some hard decisions are made. The adoption of the Gramm–Rudman–Hollings approach, and its reaffirmation last year, highlight all too vividly the extraordinary difficulty of making such choices. There are no easy answers or magic formulas. Nonetheless, economic logic and historical experience can provide a framework for analyzing the range of possible options.

I suspect that in the long run there are upside limits to the share of income that can be taxed. For several decades, the overall federal tax bite has been fairly flat, at a bit less than 20 percent of GNP, and under current tax laws will remain in this range into the 1990s. This stability over time is not a coincidence, but is indicative of the public's aversion to rising tax burdens. That sentiment was reflected in the many small tax changes in the 1970s, as inflation pushed many taxpayers into higher brackets, and in the large reductions that were enacted in the early 1980s. Of course, no one likes higher taxes, but I also sense a more sophisticated awareness of the disincentives and economic inefficiencies that seem to grow disproportionately along with the size of the tax burden. And people are skeptical that tax increases will translate fully into smaller deficits, given the reduced pressure to control spending that would result.

This does not mean, however, that revenue changes should be dismissed out of hand. Some specific taxes may serve other desirable objectives, while also bringing in needed receipts. For example, I have long urged the consideration of a sizable increase in the federal gasoline tax. A hike of 15 cents per gallon, for example, could raise close to $15 billion in revenues, while retail gasoline prices still would be well below the levels of the early 1980s. And if energy use is restrained at all, there is a further benefit.

But on the whole, deficit-reduction efforts must of necessity focus on the expenditure side of the budget. Over the past three decades, we have seen marked shifts in the composition of federal spending, accompanied by a distinct uptrend in its ratio to nominal GNP. That ratio, which reached 24 percent of GNP in the mid-1980s, has edged off in the past few years, in part because the Administration and the Congress have been relatively successful in holding the line on new programs.

I do not underestimate the difficulty of the task of further reducing the ratio of federal outlays to GNP. Several rounds of deficit-reduction efforts already have taken care of the "easy" cuts. Partly as a result, the composition of the budget has shifted toward those categories that are less amenable to control, at least in the short run. In particular, interest payments were nearly $140 billion last year, and in light of prospective deficits, are likely to grow even larger in coming years. The way to control these payments, and to get a handle on the scale of federal debt relative to GNP, is to concentrate on the remainder of federal spending and on the so-called "primary deficit"—that is, the deficit excluding interest payments (net of taxes on interest).

Looking at the programmatic part of spending, it is apparent that demographic trends, especially the shifting age profile of the population, will put substantial pressure on outlays in the years ahead. At present, 38 million Americans, or about 15 percent of the population, are collecting social security retirement or disability benefits; most of them are insured under medicare as well. That figure will rise appreciably over the next decade.

Controlling the growth of outlays is crucial and will require close scrutiny of virtually all programs. Such control, in the face of demographic pressures, will demand a willingness to take bold, controversial actions. It is essential that this Committee focus on those changes that will result in significant saving, not just this year or next, but on a lasting basis.

It would be inappropriate for me to offer suggestions on specific program actions to reduce the deficit. You know all the alternatives. The choices are political, not economic. But simple arithmetic points clearly to those areas where the scope for action is greatest. In this context, entitlement programs offer substantial opportunities for long–term budgetary savings, since they currently account for nearly half of total outlays. And with the base of expenditures certain to expand in conjunction with the increase in the beneficiary population during the next few decades, the deficit–reduction benefits of changes in the law today will accumulate over time, leading to much larger savings in the year 1995 and beyond than in, say, 1990 or 1991.

Leaving aside the serious questions of evaluating military adequacy, the budgetary arithmetic of cutting defense spending is considerably less favorable. In part, this is because the Summit Agreement already has solidified a recent trend toward reductions in appropriations from President Reagan's original overall defense plan. But more fundamentally, defense programs are essentially lumpy. A large share of spending in the early and mid–1980s went to build up our military asset base. But as we reach the requisite number of F–16 wings, air carrier groups, missile deployments, and the like, expenditures will fall back toward maintenance levels, which are significantly lower in real terms than the huge outlays of the past few years. Accordingly, reductions in defense procurement programs are not translatable, as they are in entitlement programs, into very much larger cuts in the future.

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There are, however, areas where the private sector probably can provide services more efficiently, and at lower cost, than the government. The President's Budget placed a high priority on "privatization", and suggested several activities that could be transferred out of the federal sector. I believe this emphasis is appropriate and deserves careful consideration on its own merits. But I would stress that the resulting asset sales should not obscure the more fundamental budgetary issue. Indeed, I would be troubled by the extensive use of asset sales as a long–run deficit–reduction strategy. Merely shifting the ownership of an asset from the government to the private sector has little effect on overall credit demands; moreover, it produces only a one–time budget saving.

I also would be disturbed by the greater use of federal credit guarantees, as a substitute for on–budget outlays. Such a substitution may lower the measured budget deficit, but it does not reduce the federal presence in credit markets. Both the Administration and CBO have long argued that current budgetary procedures give a misleading impression of federal credit activity. In this regard, the Administration's proposals for reform, which call for the explicit recognition and better measurement of the subsidy value of credit programs, point in the right direction.

A smaller public sector would carry significant benefits in terms of improved efficiency of the overall economy. The relationship between the size of the government and economic performance is complex, and depends—among other things—on the mix of consumption and investment in government spending. Moreover, budget figures do not capture the full scope of governmental activities on real resource allocation; the effects of government economic regulation on private activity may be sizable.

International comparisons inevitably are difficult, and the empirical evidence is only roughly suggestive of broad trends. But the disappointing macroeconomic performance of many industrialized countries over the past few decades, in the face of rapidly expanding public sectors, does raise questions about the true costs and benefits of large government expenditures. Indeed, in several European countries with sizable public outlays on income maintenance, education, and health care, those programs are coming under increased scrutiny, in part because of a perception that some of them have had detrimental effects on individual incentives and resource allocation.

To sum up, the benefit from taking credible actions to curb federal outlays and related credit demands will be enormous. Over the longer run, lower deficits will absorb less of our private saving and, all else equal, allow private investment to flourish. Moreover, a clear demonstration to the financial markets that the current services budget has been set permanently on a more favorable track will have a handsome payoff currently in terms of lower real interest rates. As I stated earlier, one way to achieve that outcome is to exploit the "wedge effect" arising from reductions in programs such as entitlements, where the savings tend to grow over time. I should note too that, in my view, you run little risk of setting deficit–reduction objectives that would be excessive in macroeconomic terms, given the broad constraints of political feasibility. And at some point in the future, it probably will be desirable to aim—not just for smaller deficits—but for outright budgetary surpluses.

In closing, let me commend the Congress for initiating the National Economic Commission. The Commissioners face an extremely difficult challenge, and I wish them well.

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Chairman CHILES. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Mr. Greenspan, some of us view the Summit Agreement that was reached last year as more a summit surrender on the deficit, with the deficit not going down but going up. Many of us believe very strongly that we need a credible plan for year-to-year deficit reduction, a reduction that would allow an easing of monetary policy so that we could get this economy moving again.

I would be interested in your view. Should the Congress stick with the Summit Agreement that was reached last year, or should we this year junk the plan and go for a more aggressive deficit reduction package?

Dr. GREENSPAN. Senator, having observed the difficulties of the budget summit last year and the extraordinary pressures which, on many occasions I thought would essentially break the process apart, I thought that it came out in the end in a way which suggested to me a commitment on the part of the Congress and the administration to reduce the deficit over the long run very much in line with the suggestions which I think you very appropriately make.

I guess I, like everyone else, would like to see the deficit come down very quickly and hopefully get that particular problem behind us.

Senator CONRAD. This is your opportunity to weigh in and urge us to do more.

Dr. GREENSPAN. Well, I am and I do, Senator, but what I hope we do not endeavor to do is to fail to recognize the areas where actual success has been made, because it is not that many years ago when the long-term current services budget was being projected up at $300 billion. And the very sharp reduction that has occurred to date is a very major improvement and, I think, one of the reasons why real interest rates have come down in part.

Having said that, it would be a great tragedy to allow the progress, which has not been unsubstantial, in recent years to be dissipated, and a program somewhat similar to what you suggest—namely, to reduce it periodically—would be beneficial. However, I would not merely scrap the budget agreement, the agreement of last fall, largely because I think you would have to put one back together again. And I think I would build from where we are as distinct from tearing apart what has already been produced.

Senator CONRAD. Well, let me ask you this way: Did the proposal that we put in place last year reduce the deficit on a year-to-year basis, in your judgment?

Dr. GREENSPAN. It reduced it from what it otherwise would be, and I——

Senator CONRAD. Well, I am not talking about that. I am talking about from the levels that we had the previous year. Did the agreement that we put in place reduce the budget on a year-to-year basis from the level that it was?

Dr. GREENSPAN. I think the deficit will be up a shade in this fiscal year.

Senator CONRAD. The deficit will be increasing?

Dr. GREENSPAN. A shade. A small amount.

Senator CONRAD. And are we to call that progress?

Dr. GREENSPAN. Well, it depends on the base where you start from. I think, for example, that no one, especially economists, would have projected a deficit of $150 billion for fiscal year 1987, nor the size of the reduction that occurred. And I would suggest to you that perhaps the base we should be looking at is not fiscal year 1987, which has, as I recall, approximately $20 billion in reductions in it from the Tax Reform Act.

I would look at the budget deficit as coming down from the $221 billion in fiscal year 1986. I think that the appropriate way of measuring the impact of the budget on the economy and the progress on deficit reduction is not to look at the year-by-year fluctuations, which I think can be aberrations, but to look at the trend. And I think if we do it in that context, our focus should basically be on fiscal year 1990, 1991 and into the future.

Senator CONRAD. If we look at a 3-year trend, 1987, 1988, 1989, and factor in the Social Security surpluses but—even if you leave those out—would you say that we have made any progress on the deficit?

Dr. GREENSPAN. If you take fiscal year 1987 as a base, then statistically I think not. But I would be quite reluctant to accept 1987 with its abnormal reduction as a base from which the rational process of budget reduction, I think, can logically proceed.

Senator CONRAD. Well, I must say I am somewhat surprised and disappointed at your answer, because I think if we are serious about doing something about the deficit, we would do a whole lot more than what was in the Summit Agreement. It appears to me the actions of the Fed belie your answer.

Dr. GREENSPAN. Well, let me say this, Senator: I do not know of anybody who liked the Summit Agreement, including the participants. And that is basically the nature of an agreement.

If you are asking me would I like to see the deficit brought down much more sharply, the answer is yes, I would. Do I believe that——

Senator CONRAD. How is that going to happen unless we tell this Congress and this administration that we ought to do that this year?

Dr. GREENSPAN. Well, I think that my notion of where this committee is headed, where the Congress is headed, and the implications of the budget summit is that the current levels, reduced as they are from their peak, are unacceptable; and that there is no tolerably acceptable budget deficit level. In fact, as I stipulate at the end of my prepared remarks, I think that zero is not enough.

I think we have to move further because of the savings abnormalities that exist in our system.

Chairman CHILES. Senator Domenici.

Senator DOMENICI. I would be glad to let Senator Symms go.

Chairman CHILES. Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman.

Chairman CHILES. Our lights are not working, so I will try to give you a little signal when your time is up.

Senator SYMMS. Thank you, Dr. Greenspan, for your very thoughtful statement.

I wondered if I could ask if you would like to comment on what the leading economic indicators meant. They were released recently—I think it was yesterday. If, in your interpretation, this means we are going into somewhat of a slower economy or a recession, what will those implications be on the budget deficit in terms of revenue to the Federal treasury?

Dr. GREENSPAN. Senator, I think the leading indicators, in total and decomposed into their individual parts, are fully consistent with all other evidence that we have about where the economy is and where it is going.

We have slowed down somewhat in the first quarter to perhaps roughly half of the slightly abnormal pace of the fourth quarter. There is no evidence, however, that we are about to tilt over into a recession.

It is certainly the case that we had somewhat abnormal inventory accumulation in the fourth quarter, but if that were about to trigger a recession, I think we would see it in a marked weakening in new orders being accepted at manufacturing establishments. At the moment, precisely the reverse is the case. The orders are strong, and it is suggestive of fairly solid, although not spectacular, continued growth throughout the rest of this year.

Senator SYMMS. Another question I am interested in is that there seems to be the specter somehow that foreign investment into business and industry and financial assets in this country is some kind of a threat to the security of the American economy. If Congress or the States individually were to start passing laws that preclude foreign investment, what would the impact be on our economy?

Dr. GREENSPAN. I think it would be very regrettable, Senator. Foreign investment is not a threat to this Nation. When such investment moves to our shores, it becomes a company which is incorporated under U.S. law; it is required to abide by the laws of the land. It in many instances acts as an ideal corporate citizen. It creates jobs; it does everything that domestic investment does. And I merely only need point to what I think is an extraordinary event in the 20th century: U.S. direct investment in Europe and elsewhere in the world, where American companies developed the economies of a lot of nations that were devastated after World War II.

I think that the very process itself, whether it is we who are doing it or we who are the recipients of it, should be encouraged, not restricted.

Senator SYMMS. I thank you very much for that answer. I was hoping that is what you would say. I quite agree with your viewpoint on that.

I do not know how my time is, Mr. Chairman.

Chairman CHILES. You get to have another question.

Senator SYMMS. OK. On page 8 of your testimony, you mentioned privatization and then in the next paragraph you cautioned about the greater use of Federal credit guarantees. I was concerned that your comments about privatization did not seem very enthusiastic. Am I misinterpreting that? Does not the privatization of loan portfolios and other things reveal what the subsidy is in them? And in the long run, would not privatizing government ownership, whether it be of land or railroads or whatever, increase the tax base, and bring some economic efficiencies, and thereby enhance government revenues in the long term?

Dr. **Greenspan**. I am in favor of that, Senator, not for budgetary reasons so much as the efficiency of the economy. But you are quite correct. It does increase revenues, and I think where we can, we should encourage it to a maximum.

Senator **Symms**. Well, I guess I am more sensitive to this than many of my colleagues on the committee, coming from a State of which the Federal Government owns two-thirds. When I hear people in different parts of the country complaining about their problems with government, I say you should move out in the West somewhere where the government is the landlord of large sections of the State. When we elect a governor, he is only governor of a third of the State. The BLM and Forest Service run the rest of it. I think maybe we are more sensitive to the complications in production, and the complications of the underutilization of the resource—even the recreational values, for that matter—because of massive government ownership. I believe the Federal Government owns about a third of all the land in the United States. There is no telling what benefits would accrue to this economy if that land were held in private hands. But I do not anticipate that happening under the current view that is most politically popular today. But maybe someday that might even change.

Thank you very much.

Chairman **Chiles**. Senator Hollings.

Senator **Hollings**. Congratulations, Dr. Greenspan.

I, like Senator Conrad, am frustrated with the casual dancing around the fire of the particular problem. We who are trying to pay the bill up here need a Federal Reserve Chairman to tell us exactly what is what. And when you finally agree and say you would like to see the deficit brought down more sharply, you should testify to that and give us the very Dickens and tell the Congress. Do not come up here and psychoanalyze and nibble around.

The truth of the matter is that, rather than reducing the deficit in the long run, that Summit Agreement did not bring it down at all. On the contrary, it guarantees that deficit will go up. Specifically, the Summit Agreement says let us spend 2 percent on domestic and defense, $8.5 billion and $8.6 billion, respectively; that is $17.1 billion. It said, let us give increases in entitlements of $36 billion. And it said we have got to pay the increased interest costs, which is $15 billion. So that is $68 billion in increased spending. And both the CBO and OMB agree on revenues, and that is only $56 billion. So we have got a $12 billion shortfall. The Summit Agreement did not bring the deficit down. It increased the deficit.

The CBO just has estimated the deficit to be $176 billion. So you have got to bring it down another $40 billion. So that is a $52 billion masking. That is why I call it the "Phantom of the Budget." And you should not be helping masking or continuing this phantom of the budget deficit.

I will bet you categorically—and the Lord willing, you and I will both be back in January—that rather than $136 billion, the deficit will be nearer $186 billion. How much do you want to bet?

Let us lay it on the line. It does not reduce it a bit. I will bet you and give you the odds it will be nearer $186 billion than it will be $136 billion. You take the odds and tell me the amount.

Dr. GREENSPAN. Senator, I would be glad to, but the unfortunate issue is if I were to take your bet, I would be forecasting; and they will not let me do that around here.

Senator HOLLINGS. Well, there. But you are testifying and you have got to tell us, and you do not tell us. You do not like asset sales; I know you do not like asset sales. When we cannot make the house payments, you do not sell off the garage, and then next year sell off the kitchen.

I mean, you know better than that, and I have heard you testify previously. Gramm-Rudman-Hollings kept up the pressure until December 1987, and then we punted. We have just about thrown Gramm-Rudman-Hollings out of the window now, and we are going to be increasing the deficit. And when it comes to taxes, Dr. Greenspan, what is our tax burden in this country, comparatively speaking, let us say, with West Germany or Japan, our competitors? It is higher or lower?

Dr. GREENSPAN. It is relatively lower than exists in Europe.

Senator HOLLINGS. Yes, well, in Europe, for example, rather than just nibbling around for $15 billion from a 15-cent gasoline tax, I am looking for a good $60 billion from a 5 percent value added tax. I need about $30 billion to get the Government started again and $30 billion on the deficit and debt.

You know that and I know that. That is the real problem. You have got the President coming here wanting more for space, more for the homeless, $100 million less on the Coast Guard. We need day care from coast to coast. We have got all of these needs standing in the line, in law enforcement, drug enforcement. So we are not going to be cutting down the size of government. You are never going to get a better government-cutter than Ronald Wilson Reagan. And after 8 years of him, it has been a standoff. We need a trillion dollar government, and we are only going to collect $800 billion. You ought to be telling us we cannot continue that.

Dr. GREENSPAN. Well, I thought I was, Senator.

Senator HOLLINGS. No; the best you did, you danced around it and came up with 15 cents on a gallon of gas. That is a pitiful presentation for the head of the Federal Reserve and a man of talent and ability that you have. You cannot be tippy-toeing——

Chairman CHILES. It is the best I have ever seen out of any chairman of the Fed.

Senator HOLLINGS. Yes; you have got the 15 cents; you finally mentioned the word "tax."

But, for heaven's sake, let us lay it on the line so we will know the job to be done.

Dr. GREENSPAN. Senator, I have been appearing before this committee for a number of years. I am fully cognizant of the fact that every member of this committee knows the full detail of where all the potential cuts are. I cannot conceive of a Federal Reserve Chairman coming up here and creating any new list of means by which the deficit can be closed.

Senator HOLLINGS. There is no alternative to taxes. We have had a free ride. You know it.

Dr. GREENSPAN. Yes. I must say this is an extraordinary experience for me to be sitting here and essentially being positioned where I am soft on the budget deficit. I must admit, it is a real remarkable experience.

Senator HOLLINGS. That is right, and you ought to realize it. If you were advising me as governor, you would say, "Governor Hollings, you had better hurry up and pay your bill or you are going to lose your credit rating." That is the first thing Alan Greenspan would tell me. But for the President of the United States, you dance all around and find a 15-cent gasoline tax and say watch these asset sales, and make the categorical statement we got pressure on the deficit and the Summit Agreement reduces the deficit, when we know that is totally false.

Dr. GREENSPAN. Well, no, I do not quite agree with you on that specific point. I do agree with you pretty much because as you know, Senator, I have agreed over the years, with your general approach to the deficit.

There was benefit from that Summit Agreement, not as much as I would like; in my judgment, not as much as virtually anybody on that committee would like.

Senator HOLLINGS. It gets us all re-elected in November. That is all.

Dr. GREENSPAN. Well, all I can say to you is that I understand what is in the process of occurring is a growing commitment on the part of the Congress to resolving this budget deficit issue one way or the other. I must say to you I take comfort from listening to the discussions that have been going on in the last several years on the issue of the desired direction of the deficit. And the impression I get is that no one is willing to throw in the sponge; there is just continuous pressure. And all I can say to you is that I know of no conceivable reduction in the budget deficits that can occur in the short run that that could do anything but good for the economy.

So all I can say to you is I wish you well, and I do not think you need me to tell you how to do it.

Senator HOLLINGS. Thank you.

Chairman CHILES. Senator Grassley.

Senator GRASSLEY. Thank you.

Chairman Greenspan, I want to start where Senator Symms left off in his questioning to you about the prospects of a recession, and you answered short term. My question is a little bit more long term in light of the fact that we are in a period of what we are told by the administration is the longest peacetime recovery that this country has ever seen.

When are things going to change? Because we know that cannot go on forever. I ask my question to you in light of your position being fairly insulated from politics, at least not responsive to politics, and, coming maybe from a person like you, friendly advice as to what might be down the road so we can anticipate it and make changes so it may not be quite as drastic as we know sometimes happens in this country with a long period of recovery.

Dr. GREENSPAN. Senator, I would answer that in two parts. First, there is nothing that I know that suggests that we have cured the business cycle. There is another recession out there. The question, basically, is when.

In that regard, it is instructive when one examines the length of economic recoveries—and this is statistically the longest in peacetime history—what you find is that how long the recovery has been going does not help you very much in predicting the next downturn. As I said in an earlier hearing, we do not have any significant geriatric characteristics in this recovery. In other words, it does not look like an aged recovery if you look at the relationships between the levels of inventories, the lead times on the deliveries of materials, and commodity prices.

In other words, we do not have right now a lot of those symptoms which signal the tail end of a recovery. They will occur, and we will have a recession at that point. What I am saying, however, is you cannot really find many of the early signals of that at this point.

Senator GRASSLEY. Let me go on to another subject, then. I am not sure I am totally satisfied, but I want to cover another item.

Our Government, our political leadership has been very aggressive in the last year to 2 years of bringing down the value of the dollar in relationship to the major currencies. Do you think that that ought to be extended? In other words, would you be advising that same vigorous effort towards reduction of the value of the dollar in relationship to lesser currencies in the world, where we still have a very unfavorable balance of trade with some of those countries—Korea, Taiwan, Singapore, Pacific Rim countries, to name some where the value of the dollar has not changed any recently?

Dr. GREENSPAN. First of all, I would not say it has been the policy, with the exception of the period immediately following the Plaza Agreement, to drive the dollar down in a conscious manner. But on the issue of the lesser currencies, as you call them, I think there are already pressures in the marketplace for the exchange rates of those countries to begin to adjust to economic realities.

Clearly, we are desirous of seeing those adjustments take place, and I think, to the best I can judge, they are in the process of doing so.

Senator GRASSLEY. But you are saying that is being done through the marketplace and not political, as there was a political decision with the conference you referred to?

Dr. GREENSPAN. Well, I think that we have communicated appropriately to the various parties involved that we think that they were basically fighting market forces; and that if they just allow market forces to function, you would get an adjustment.

For example, the extraordinary accumulation of reserves by Taiwan—it is my recollection it is in excess of $75 billion—suggests to anyone who is looking at the situation that the balance is inappropriate and that, presumably, the currency is incorrectly calibrated.

Senator GRASSLEY. Thank you, Mr. Chairman.

Chairman CHILES. Senator Fowler?

Senator FOWLER. Thank you, Mr. Chairman.

Dr. Greenspan, explain something to me in strictly layman's terms. I must be missing something. If you look at all of our industrialized world and add up the exports on one side and the imports on the other side, they ought to equal, should they not? And what I do not understand is that every time I try bringing in all the figures, which are a little hard to get, especially on a quarterly basis, all of our allies, all of our major trading partners—EEC, Canada, the Japanese—the exports usually run $60, $80, $100 billion over the imports.

Now, I can understand why it would be in the domestic interest of a sovereign nation, the domestic political interest of a sovereign nation to overestimate their exports. But I am wondering whether or not you find the same phenomenon that the books do not balance, and whether or not you feel like we can trust the figures.

Dr. **Greenspan**. Well, Senator, on the merchandise accounts—

Senator **Fowler**. We have a specific problem with Canada, as you know. We have to go back in.

Dr. **Greenspan**. That is correct.

Senator **Fowler**. And we found out that the Canadians were basically right.

Dr. **Greenspan**. Yes; I think that——

Senator **Fowler**. Now, is that also happening in Japan and the EEC?

Dr. **Greenspan**. Not to our knowledge. There are a few technical problems in the way one evaluates this. Sometimes if you get a reporting in which included in imports is freight and insurance costs, and as a consequence, sometimes when you add up all of the exports, they will not equal the imports because the imports include not only the value of the exports, but for individual countries all freight and insurance costs as well.

Senator **Fowler**. That would be minimal, would it not?

Dr. **Greenspan**. It is not a big thing.

Senator **Fowler**. It would not be $50, $70, $80 billion off.

Dr. **Greenspan**. No, but it is not. If you adjust the imports to the same export values, meaning FOB port of embarkation, then for the world as a whole, there does not seem to be a significant imbalance.

There are a number of countries for whom the data are so poor that the numbers for imports into industrial countries are used as proxies for the exports of countries for whom the data are really quite poor. But if you add up the industrialized countries' imports and exports, the developing countries, including the OPEC countries, I think you will find that for the trade balance, it comes out reasonably close. The world statistical discrepancy is quite small.

However, if we are talking about the broader measure, the current account balance, which includes mainly imports and exports of services as well as the trade accounts, then we do have a chronic world deficit, so to speak, in the statistics—which, of course, cannot exist.

In short, we seem to be underestimating some of the services, presumably the investment income accounts, of a number of countries. But as best as I can judge, the trade data, when properly evaluated, seem to come out OK.

Senator **Fowler**. Well, I would like to pursue this with you at another time. It is becoming very difficult to figure out what you can believe. I think it is very hard to frame the debate any more, after 10 years in this business, because when you get into trade, or even our domestic accounts, everybody does it differently. And I am not talking about political parties and Presidents.

As you know, if you are in France or England and they have the situation that we have had in this country, where you have got 38 or 39 States in surplus, those surpluses, were they in most of our trading partners' countries, would be counted in the national accounting system—I am not suggesting this to the President and his administration, because we may see that next week as a way to further lessen our budget deficit. But as you know, there are many countries where there would be an extra $100 billion, or whatever it is, there as an offset to our deficits if we used the accounting system that they had.

On the other hand, on this export-import issue—I appreciate your answer, and I want to think about some other things and pursue it at another time. But I think if you will go back and look, the difference between the world exports and world imports are $100 to $160 billion off on the export side, which is not possible. It is certainly not accountable just by insurance and freight charges and things like that.

Dr. GREENSPAN. No.

Senator FOWLER. Anyway, I wish you would look at that. And if you have some bright people who have got some papers on this to show me how those two can reconcile, I would very much like that.

Dr. GREENSPAN. Why don't I send you a note on that, Senator.

Senator FOWLER. I would be very appreciative. Thank you.

[The following was subsequently supplied for the record by Dr. Greenspan:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

March 15, 1988

The Honorable Wyche Fowler, Jr.
United States Senate
Washington, D.C. 20510

Dear Senator:

During the hearing before the Senate Budget Committee on March 2, you asked for some help in reconciling the data on world exports and world imports.

International organizations have devoted much time and effort to improve the quality and usability of international trade statistics, trying to ensure that the country coverage is comprehensive and that the various components are reported on a consistent basis. Partly as a consequence, one can find several different measures of aggregate trade flows.

Enclosed is a copy of a table from the IMF's World Economic Outlook, published in October 1987. The line indicated by the arrow confirms that reported world exports generally exceed world imports, i.e., the world's trade balance is generally positive, with the excess estimated at an average of about $12 billion per year from 1979-1987. These data have been adjusted to take the cost of insurance and freight out of import data so that exports and imports are on a comparable (F.O.B.) basis. Part of the excess of exports over imports in periods of expanding international trade reflects the fact that exports generally are recorded before imports; estimates of this "timing asymmetry" are shown in the table. The remaining asymmetry averaged only about $5 billion over the period 1979-1986, and does not show a systematic bias toward an excess of exports over imports. With the total value of world exports on the order of $2 trillion, a discrepancy of that magnitude is not too surprising.

I hope this information is useful. Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Table A30. Summary of Payments Balances on Current Account, 1979–88[1]

(In billions of U.S. dollars)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Industrial countries	**–23.1**	**–40.5**	**–18.7**	**–22.3**	**–19.5**	**–58.5**	**–51.4**	**–18.1**	**–38.9**	**–44.2**
United States	–1.0	1.9	6.9	–8.7	–46.3	–107.0	–116.4	–141.4	–152.1	–140.6
Other industrial countries	–22.1	–62.4	–25.6	–13.6	26.7	48.5	64.9	123.3	113.2	96.4
Of which,										
Japan	–8.8	–10.7	4.8	6.9	20.8	35.0	49.3	85.8	85.1	83.2
Germany, Fed. Rep. of	–6.0	–15.7	–5.2	4.1	4.2	8.4	15.2	37.2	40.7	32.5
Developing countries	**6.4**	**30.4**	**–48.5**	**–87.1**	**–64.2**	**–33.8**	**–23.9**	**–47.0**	**–19.6**	**–19.3**
By region										
Africa	–3.4	–1.9	–22.4	–21.5	–12.3	–8.0	–0.1	–9.4	–7.5	–6.1
Asia	–9.7	–14.4	–19.0	–17.4	–14.9	–4.2	–14.0	4.9	15.3	10.0
Europe	–13.6	–15.6	–14.3	–8.7	–5.9	–3.2	–3.3	–1.7	–2.3	–2.5
Middle East	54.2	92.5	50.0	3.0	–20.1	–15.8	–2.2	–23.3	–12.1	–7.0
Western Hemisphere	–21.1	–30.2	–42.7	–42.5	–10.9	–2.6	–4.3	–17.5	–13.1	–13.8
By analytical criteria										
Fuel exporters	51.4	95.9	34.8	–18.2	–19.5	–5.4	3.0	–37.9	–11.9	–4.7
Non-fuel exporters	–45.0	–65.5	–83.2	–68.8	–44.7	–28.4	–26.9	–9.2	–7.7	–14.6
Market borrowers	–29.2	–35.8	–71.9	–73.6	–30.0	–3.5	7.0	–2.3	13.0	7.4
Official borrowers	–5.7	–9.0	–12.0	–10.5	–8.6	–9.9	–9.4	–8.3	–9.8	–9.7
Other countries[2]	**–2.7**	**0.8**	**–3.0**	**2.4**	**2.7**	**4.8**	**2.3**	**–0.2**	**0.7**	**0.6**
Total[3]	**–19.4**	**–29.2**	**–70.2**	**–106.9**	**–81.0**	**–87.5**	**–73.1**	**–65.3**	**–57.9**	**–62.9**
Memorandum										
Total, by selected categories										
Trade balance	21.3	30.1	16.7	–3.0	2.9	8.5	9.1	9.7	15.4	16.7
Timing asymmetry[4]	26.2	11.3	–3.3	–9.4	0.9	–1.2	12.5	9.7	16.0	14.0
Residual asymmetry	–4.9	18.8	19.9	6.3	2.1	9.7	–3.3	—	–0.6	2.7
Balance on services	–30.7	–45.1	–74.8	–89.3	–73.6	–86.1	–71.3	–60.9	–57.0	–62.3
(in percent of service payments)	–5.1	–5.8	–8.5	–10.2	–9.1	–10.2	–8.5	–6.5	–5.4	–5.4
Private transfers net	1.1	0.2	0.4	–1.5	0.2	2.0	1.8	3.2	3.5	4.6
Official transfers net	–11.2	–14.4	–12.5	–13.1	–10.5	–12.0	–12.7	–17.4	–19.8	–21.9

[1] Including official transfers.

[2] Covers estimated balances on current transactions only in convertible currencies of the U.S.S.R. and nonmember countries of Eastern Europe.

[3] Reflects errors, omissions, and asymmetries in reported balance of payments statistics on current account, plus balance of listed groups with countries not included.

[4] Staff estimates of the difference between the beginning-of-year and end-of-year "float," that is, the value of those exports that have not yet been recorded as imports (usually because the goods are in transit or because of delays in the processing of the documentation). The estimates should be viewed only as rough orders of magnitude.

World Economic Outlook
International Monetary Fund
October 1987

Senator **Fowler**. Mr. Chairman, has Pete not had his time?

Senator **Domenici**. I have not and neither has he.

Senator **Fowler**. Well, I will relinquish then. Thank you very much.

Senator **Domenici**. Thank you, Mr. Chairman.

Let me see if I can ask you what the primary deficit means. You gave us a very simple definition: deficit minus interest payments. Now, maybe I am doing something wrong, but in 1987, under that definition, the interest payments equal $139 billion, the deficit equals $150 billion. Do the subtraction and the primary deficit is $11 billion.

Dr. **Greenspan**. What you have to do in that calculation, Senator, is to take the interest payments after tax receipts. In other words, to the extent that the interest is income which is taxable and, hence, part of the revenue side of the budget, then you have to reduce it—I do not know what the actual number is. Maybe by $20 billion or thereabouts. But that is correct.

If you take the $11 billion and add back in, in a sense, the tax effect on the interest paid, you get a number which is clearly $30 to $50 billion, something in that area.

Senator **Domenici**. So your definition of a primary deficit for 1987 is somewhere within the $30 to $50 billion range instead of the $11 billion, which I get by simple arithmetic?

Dr. **Greenspan**. Well, actually, we do have a number. I just do not have it available with me, and I will submit that number for the record.

Senator **Domenici**. I would appreciate it. The reason I was so impressed with $11 billion in doing the arithmetic is that I was going to remind you that we would wipe it all out without doing anything else if you reduce interest rates 1 percent. Rather, it does prove my point that, you know, we keep going round and round with interest rates feeding the deficit and the deficit feeding the interest rates if that is the primary and singular measure that we use.

[The following was subsequently supplied for the record by Dr. Greenspan:]

PRIMARY DEFICITS

The primary deficit for Fiscal Year 1986 was $132.9 billion and for Fiscal Year 1987 was $59.2 billion.

Senator **Domenici**. Now, let me ask you two things. I want to focus quickly on two issues. Some Senators now have circulated—not this Senator and, to my knowledge, no one on this Committee—but some have circulated a flow chart through the year 2020 of the Social Security Trust Fund, indicating its accumulation of reserves under various economic scenarios.

Seven, 8 or 9 years out from now, there is a huge accumulation of surpluses. You know why that was built in. You were on the commission. In fact, you were one of those most responsible for doing that. Let us assume for purposes of this discussion that, at some point in the recent future, not too far out, we get a trillion dollar reserve in the Social Security Fund.

Now, macroeconomic-wise and as chairman of the Federal Reserve, how do you perceive that huge fund versus our annual deficit? Do you perceive the surplus in terms of a savings account?

Dr. GREENSPAN. No, sir.

Senator DOMENICI. All right. Well, how do you perceive it? I guess we ought to say for the record you can only use it under current law for investment in the debt of the Federal Government.

Dr. GREENSPAN. That is correct. And as a consequence, it is a bookkeeping adjustment. It is not something which anyone who is involved in evaluating the net demands for credit by the Federal Government pays very much attention to, because it is an intragovernmental transfer.

As far as evaluating the impact of the Federal deficit on the financial system and on the economy as a whole, so long as the holdings of the Social Security Trust Fund are in U.S. Treasury obligations, then it is a wash. And the unified budget is the only one which we pay particular attention to because it is that which creates the net demand for credit, the net effect of the Federal deficit. And I would be concerned if one would perceive of that as in some sense some large savings. Because, remember, the obverse of that social security surplus is invariably going to be a deficit in the accounts of the Federal Government excluding the social security system. If it were not the case, then we would be running a very significant surplus on the unified budget concept.

Senator DOMENICI. Well, I guess I just want to ask you this very practical question. I think it will apply ultimately here, but it surely will apply as these commissioners that are appointed for the economic commission.

Just very practically, if in 6 years the Social Security reserves under a unified budget wipe out the deficit for that year and create a surplus for that year, how do you look at that?

Dr. GREENSPAN. You mean on a unified basis.

Senator DOMENICI. On a unified basis. You say unified basis is what we ought to continue to use.

Dr. GREENSPAN. Yes, sir.

Senator DOMENICI. So you keep social security on that unified budget. It has a huge surplus compared to the annual deficit. So in that year you might be on the plus side in terms of the annual operations of the government.

Is there no longer a deficit in that year, then?

Dr. GREENSPAN. For the consolidated U.S. Treasury accounts, there is no deficit.

Senator DOMENICI. Is that considering how long it will take before that fund is depleted? Is that a salutary situation?

Dr. GREENSPAN. I would say that obtaining a surplus on the unified budget concept, irrespective of how it is achieved, is a desirable end in the long term because we have a shortfall of domestic private savings in this economy, which we do not seem to be able to reverse.

Senator DOMENICI. Now, let me move to how you set monetary policy. Again, I believe that you have told us about the deficit here, and we all know about it. We would like to know a little bit about monetary policy.

I am somewhat concerned, to tell you the truth. I think real interest rates are still too high. I am very fearful that there are people around warning that any substantial reduction in interest rates will be politically motivated. I want to make sure that you hear from some who do not want the reverse to happen; I would not want you to be accused of keeping rates too high because of political motivations.

However, I think your predecessor, after a couple of years of struggle, finally got around to using some very objective measurements of money supply upon which the Federal Reserve predicated its activities vis-a-vis interest rates. I now hear—although no one is privy to your private meetings—that members of your board other than you are suggesting that the Fed is watching a number of other indicators. And if these are not actually targets, they are sort of a monitoring device.

I have heard it said you keep an eye on commodity prices, the dollar, the so-called yield curve. I frankly believe that that puts the board into a position where they may not be motivated by clear-cut targets, but rather by judgments. Frankly, I think that is a very dangerous path.

Could I get your observations on that? And I understand you are merely a member, the chairman, and you have a difficult time. You have to have majorities. But I am telling you my own honest concern, and I really do not believe there is any justification for real interest rates being higher today than 2 years ago based upon the simple premise of the deficit, because the deficit is coming down. A 1.9 percent of GNP reduction in the deficit is pretty good. If you do that every 3 years, you will be out of deficit in about another 4½, 5 years, which is not all that bad.

Dr. **Greenspan**. Senator, first let me say I am not certain that I agree that the long-term real interest rate is higher than it was 2 years ago. The reason I say that is that what we are dealing with is a judgment about what the market's long-term inflation expectation is over the life, the full maturity of the debt instrument to which it is applied.

Senator **Domenici**. Dr. Greenspan, I am going to miss the vote if I do not go.

Dr. **Greenspan**. Sure.

Senator **Domenici**. I will try to pick it up in a minute.

[Recess.]

Chairman **Chiles**. Dr. Greenspan, last year we faced two major program default crises. One involved the need to recapitalize the Federal Savings and Loan Insurance Corporation; the other involved shoring up the Farm Credit System. In both cases, the Federal Government recognized its responsibilities with respect to these institutions, and Congress and the President agreed on legislation to bail out these federally chartered institutions.

In both cases, we put the activities off budget as if the Government had no responsibility for their financial activities. But in reality, everyone in town knows that if an exceptionally sour economy spells trouble for these newly created corporations, Congress will not be able to resist, and it will have to step in and pick up the pieces.

Already this year, I am aware of proposals that set up at least five more of these federally chartered corporations to perform a host of activities when ordinarily we simply would create a new grant or direct loan program to fund. In fact, there is now a form letter that floats around to the Congressional Research Service: Please draft legislation that will follow the legislation we have already drafted to make sure there is an off-budget institution.

I am concerned about the amount of new Federal liability we are generating with off-budget institutions said to be private. Does this trend of shifting costs off budget concern you? Do you feel that Congress should do a better job of weeding out the prospective liabilities of various federally chartered corporations so that those that are taken off budget are truly those which are expected to have no direct Federal cost, even if they experience hard times?

Dr. GREENSPAN. I would certainly support that, Mr. Chairman. The reason why we are concerned about the budget deficit is because fundamentally it is a claim upon the savings of the private sector. And as a consequence, when the deficit becomes inordinately large it creates financial abnormalities and acts as a claim on a very substantial part of the private savings flows.

Whether or not you put those types of activities on or off budget, they nonetheless directly absorb private savings; if we are dealing with a Federal guarantee, the effect on resources is the same. There is no distinction between being on budget and off budget, and as a consequence of that, most analysts who endeavor to measure the impact of the Federal budget deficit will take those off-budget activities and put them back on for analytical purposes.

Chairman CHILES. So what you are saying is, in effect, the private sector and the analysts and forecasters, are doing their arithmetic and we are fooling ourselves if we think we are creating something?

Dr. GREENSPAN. Yes, sir.

Chairman CHILES. Last year, when Paul Volcker appeared before our committee, he spoke about the perils of the United States continuing to live beyond its means. He said that we are spending more than we produce, we are unable to finance at home both our investment needs and our Federal deficit, and those conditions are not sustainable for long. At present, the influx of capital from abroad cannot be traced to the surge in productive investment. In other words, we are not borrowing to increase as much our investment as our consumptive appetite. And he said it is not sustainable from an economic perspective to pile up foreign debts while failing to make the investments we need both to generate growth and to earn money to service the debts. And it is not supportable politically as the pressures on our industrial base are transmuted into demands for protection.

Of course, he went on to say that these are creating a burden for future generations. We certainly know that.

We know it has been very hard to rally the troops behind a major deficit reduction because for a long time, it seemed that the problems they would bring were so distant and abstract. Now we are beginning to see some tangible effects from our massive international indebtedness. Foreigners are beginning to cash in some of their IOU's, beginning to move some of their funds from their treasury notes into capital assets. Last year, direct foreign investment increased 50 percent to $38 billion.

I note in your testimony that this is not all bad, and that in this perspective the Japanese still do not own the United States—only about 2 percent of it, I think. But it seems that in spite of this there are dangers. I cannot say I am comfortable with the foreign money that is flowing into PACs, for example. Many companies who contribute to PACs, have become subsidiaries of foreign corporations and I wonder about the potential for mischief there. I am a little uneasy about the way State and local government are beginning to fight among themselves to offer incentives to attract the foreign plant or the foreign investment.

I would like to get to the basic cause of this foreign investment. Of course, at the root of it, the United States has been living beyond its means for too long. Is it not true that when a Nation is an international debtor it has to honor those debts by giving up some of its output and its assets? Is that not what we are beginning to see now?

Dr. GREENSPAN. That is exactly right, Mr. Chairman. when one becomes a debtor it means that you are borrowing foreign savings that you must pay interest on, which in a sense is claims to real resources. And when we have, as we do today, a very significant current account deficit, that is, in fact, a measure of the net savings from abroad which is required to balance our accounts in the United States. And it is a very good measure of the extent to which, as Chairman Volcker indicated last year, we are living beyond our means. In a sense, we are consuming as a Nation more than we are producing, and that difference is succinctly measured by the current account deficit.

Chairman CHILES. Is that not, Dr. Greenspan, a sort of a mathematical equation that has to balance out?

Dr. GREENSPAN. Yes.

Chairman CHILES. There is no fairy to take away that current account deficit and balance it up. How do we get that message across to those here and to the American public that there is no free lunch, that we are locking ourselves into a lower standard of living, or someone in the future, as we continue that practice?

Dr. GREENSPAN. It is very difficult to do, largely because we are dealing with an abstraction. We see the issue of imports and exports coming to and leaving our shores, and we see the issue of investments coming here and production and consumption. But it is very difficult to pull all of this together and to successfully communicate it. You can summarize all this diverse degree of activity into a very simple abstraction, which is essentially the ratio of foreign savings used to finance domestic consumption.

You are quite correct; it is arithmetically necessary that the current account deficit equal capital inflows, and the laws of arithmetic will never be repealed. And as a consequence of that, there is no way of getting around this issue. We will either reduce the current account deficit, or we will continue with very substantial net accumulations of claims against the United States in terms of either holdings of securities or generally direct investments in physical facilities in the United States.

Chairman CHILES. I think we are beginning to. Maybe that will come home to the American people. It is certainly coming home to some when we see names like Firestone with a foreign prefix attached. I stayed recently at one of our old, major hotels on Park Avenue. When I got to my room, I noticed a little pin in there that said Niko Hotels International now owned the old Plaza Hotel. If people think about it, maybe some of that will come home.

In the Federal Reserve's monetary report to Congress, you speak of the need to contain inflationary pressures. Because the dollar has declined so much in the past few years, it looks like the main source of any inflation is likely to be from more expensive imports.

Of course, if we are to get our imports down, which is really the stubborn part of our trade program, we are going to have to let those import prices rise. That is the only way Americans are going to start buying more of our goods and less from foreigners.

I know that is a heck of a lot better way to get the trade deficit down than through slow economic growth or even recession. I guess the trick is how we let import prices rise but not let that start a wage-price spiral. Could you tell me how you intend to do that?

Dr. GREENSPAN. Well, I think, Mr. Chairman, you are raising one of the crucial dilemmas of the adjustment process; namely, how to recognize that we, in fact, need the full flow-through of exchange rate adjustments into domestic import prices. Because it is the prices, not the exchange rate, as you point out, which influence the share which Americans have of their total purchases that are imports and which are purchases from domestic suppliers.

The failure of prices to rise for imports in the United States in the last couple of years, or I should say the last 3 years, to the extent that the dollar's exchange rate has fallen, reflects a very substantial contraction in profit margins on goods shipped to the United States. And we suspect that margins probably are close to bottom, which suggests that even as we expect the dollar to remain flat, import prices are likely to start to continue to rise, largely because the effect of the flow-through is not yet complete.

However, as best we can judge, the size of the import price increase, which depending on whether you are including oil or not including oil, is in the area of 10 percent annual rate, slightly less. And if we can keep the value-added prices of domestically produced goods in the range where they have been in the recent past, then we will not have anything resembling an inflationary surge.

So while it is certainly the case that there is still a remaining inflation push coming from import prices, it does not appear to be of an order of magnitude which should create considerable concern. But it is unquestionably one of the elements that we are looking at, for if we are wrong on this, the mistake is very likely to be on the side of too much inflation rather than too little. That would concern us.

Chairman CHILES. Last October, the markets gave a resounding vote of no confidence to the policy of supporting the dollar at a level that could be sustained only with higher interest rates. To your credit, the Federal Reserve did an aboutface, and let the interest rate, then the dollar, move lower.

Now, it looks like that we have signed on, again, to supporting the dollar near its current levels, even though there seem to be a lot of people out there who believe it will have to come down more to turn our trade deficit around. One of the things that bothers me about regaining our international price competitiveness through a dollar depreciation is that it makes us poor. It would be far better, it would seem, to become competitive through strong productivity growth to raise our standard of living while we are becoming competitive.

Do you think the dollar has come down enough to get the kind of improvement that our present policy seems to need in its trade accounts?

Dr. **GREENSPAN**. Well, it is fairly apparent, Mr. Chairman, in line with the comments I just made that we still have a considerable amount of adjustment coming through the trade accounts as a consequence of the exchange rate changes which are already in place. And the adjustments, as we see them, suggest that the trade balance will continue to decline over the longer run in nominal terms, although the adjustment we do not perceive to be rapid, and it probably will be erratic. That is not inconsistent with the exchange rate remaining stable.

Chairman **CHILES**. Well, it seems that basically there are two directions you could go. One is to make yourself stronger through productivity, and the other is to make yourself poorer and balance out that way. Historically, when we enjoyed high straight surpluses, our dollar was at its highest. So it did not seem to be affecting those surpluses negatively.

Dr. **GREENSPAN**. No, in fact, Mr. Chairman, I would say that a not insignificant element in the improved trade performance that we have seen in physical volume terms has occurred as a consequence of a fairly pronounced improvement in manufacturing productivity in this country, increased efficiency, which results from trying to improve what was clearly a non-competitive position. And if you look at the data, we have come a long way in that respect.

Chairman **CHILES**. How much further do you think we have got to come in productivity gains to sustain an improvement with the dollar at this level?

Dr. **GREENSPAN**. I do not know the answer to that. That is, of course, the crucial question, and we have not been able, in my judgment, to answer that question acceptably. But we certainly know we are moving in the right direction, and I think what we have to ensure is that we recognize that the real gain in international competitiveness comes not from exchange rates but from underlying productivity.

Chairman **CHILES**. In a speech given Monday to the managing directors, the International Monetary Fund urged Third World debtor countries and commercial banks to begin sharing the discount available on debtor country loans. That seems to make some sense. Investors buying the debts of the least developed countries on the secondary market these days get it at a discount that sometimes is substantial. The debtor countries on the other hand are obligated to pay off the loan at its full face value. They get no relief from the market discount on their loans. It seems that we need to set the stage for strong growth in these parts of the world so we can export more.

The Mexican debt swap plan devised last December was an attempt to change this status quo, and now the International Monetary Fund seems interested in pushing the same thing. By liberalizing Regulation K, the Feds made it easier for the U.S. banks to swap their debt for equity. This, too, will help make discount sharing a plausible counter to the debt crisis.

While I am happy about these developments—and they certainly seem to be in the right direction—I have one concern I want to ask you about. We have learned from the Mexican swap that the European and the United States regional banks seems to be most well positioned to swap their Third World debt for other obligations and to pass along some of the discount for that debt. Are the money center banks as well positioned? If they began to participate in programs like the Mexican swap plan, what would be the effect on their capital structure and on the stability of the U.S. financial system in general?

Dr. GREENSPAN. Well, I think that you are dealing with an issue which is exceedingly complex and fluid at this stage. I believe that the managing director of the IMF was emphasizing that those changes be voluntary; and, indeed, the Mexican swap is a voluntary arrangement. Changes in Regulation K are voluntary.

The reason why I emphasize that is that it is perfectly plausible for debtors and creditors to decide at some point to, in a sense, swap out an existing obligation. But I think what we have to remember is that what we are dealing with is a situation which will be resolved fundamentally in all respects only if we get a set of sustainable economic policies amongst the debtor nations that will eventually create growth rates and viability, and which will recreate access to the private financial markets.

If we in any way introduce a series of shortcuts and, in the process, we undercut what I believe is an emerging trend towards successful ultimate access to the international financial community, then I think we sever the private credit ties to the developing nations for a long period of time, and that would make them, essentially, through their external financing, the wards of other governments.

And I think that is wholly unacceptable to everybody. We should not forego what is a slow, tortuous, often difficult process which we are currently engaged in for the quick fix. And in my judgment, it will be difficult, it will take a while, but we are going in the right direction.

I do believe we will ultimately see that the developing nations who are deeply in debt will find the correct policy mix which will get them back access to the markets, and that rather than throw in the sponge, the creditors, I think, will find that what they hold on their books at this particular stage will be materially more valuable.

Chairman CHILES. I think that is a very good answer, and I know it is a complicated subject. It is not easy for me to understand it myself. But you did not speak to the problem that I raised. In our effort to allow this to happen, albeit voluntarily, where, in effect, in the Mexican swap we are allowing our banks and others that have that debt to get something that is real at about a 50-percent discount, the U.S. coupon bonds, that is more appealing to the regional banks who do not have the kind of indebtedness and to the European banks who are not loaded up with a debt.

It has got to be somewhat less appealing to our money center banks who perhaps do not see how they can take a 50-percent discount, although some of them are trying to write that debt down as fast as they can.

I am asking, even through these steps do we have to be concerned as to whether we are putting the money center banks in a more difficult spot where they are less viable as they try to roll over any of this debt.

Dr. GREENSPAN. Well, let me just indicate that it is the money center banks in the United States which have been those most committed to Latin America and financing Latin America. They view the process as essentially a long-term process and these are long-term, important customers of these money center banks.

As a consequence, they would tend to value this process to a higher extent. Now, they will value these loans more than will others, whether they be European or regional banks, which are more peripheral lenders to Latin America.

Hence, they are not willing to sell them at a 50-percent discount because they think they are more valuable than that. That is, I think, because they view this in a longer-term context.

Is it a problem? Of course, it is a problem for them, and they have been very consciously aware of the means of assisting, where they can, these countries to get back onto a full, voluntary, private debt-servicing capability.

Chairman CHILES. Senator Domenici.

Senator DOMENICI. Senator Nickles can go ahead.

Chairman CHILES. Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you very much.

Dr. Greenspan, it has been interesting listening to several of your comments. To get into an issue that I have raised with a few of our guests—and a concern that I have is our Federal budget deficit, but even greater than that is our real budget deficit if you took out all the surpluses that we have in the trust funds.

It has been mentioned, social security, and social security this year in 1988 will have a surplus of $37 billion and medicare will have a surplus of $15 billion. As a matter of fact, if you add all the surpluses up for 1988, you have, basically, in the individual trust funds a surplus of $97 billion. For 1989, it is, I think, $112 billion, and that increases substantially in the outyears.

As a matter of fact, in 1993 it is estimated that social security alone will have a surplus of $97 billion, and total surplus of all the funds in 1993 will be $161 billion. So, really, when you were mentioning in response to Senator Conrad's comment that, well, the deficit prediction or trend is coming down, really, as I am looking at it, the trend is coming down because you have surpluses coming from social security and, to some extent, military retirement, civilian retirement, unemployment comp, and airport and highway trust funds.

Really, the surplus is coming from the taxes from those individual trust funds which are shown on paper, not in reality, in this Senator's opinion. On paper, they are showing great surpluses, but the real operating deficit of the country continues to be around—

next year it is projected to be $242 billion and, really, $240 or $250 billion for the next several years if you take the trust fund surpluses out. That concerns this Senator.

Does it bother you if, in the year 1993, let us say, for example, we have a balanced budget, as accounted for right now, but in reality $100 billion of that was surplus in the Social Security Trust Fund? Well, let us say $160 billion of it was surplus trust funds.

We may have a balanced budget by the year 1993 but, in reality, we are stacking up enormous liabilities for the future years that these trust funds are supposed to be providing money for.

Dr. GREENSPAN. Well, Senator, it depends on the form in which you evaluate the deficit itself. From the point of view of where I think it matters most—namely, financial analysis, because that is the way it impacts mainly on the economy—the appropriate way of looking at the budget is on a unified budget basis, in the sense that the surpluses in the various social insurance trust funds are being invested in U.S. Treasury securities. That means, in effect, they are financing other expenditures, as you point out.

And it is essentially the consolidated total which eliminates these intra-budgetary transfers that I think is the relevant consideration. In other words, if we are to look at it from an economic point of view, I think it is appropriate to look at it in terms of the unified deficit.

And for operational analysis, I certainly agree with you on looking at it from the point of view of where the surpluses are and where the deficits are and how to allocate taxes, which is essentially what is involved here. But from an economic point of view, it does not matter.

Senator NICKLES. Well, let me ask you, to further that question, OK, theoretically it looks like we are on that path; that we are going to have declining deficits for the next several years if we are able to do any kind of a decent job, just basically because we have the built-in increases primarily in Social Security tax and hospitalization tax. So we get there.

In the year 2010, 2015, you are going to have enormous liabilities in all of these social trust funds, social security, medicare, civilian retirement, and military retirement. The bills are going to be coming due, and what those trust funds have in them are government bonds. In the past, the only way they have been financed is by the reissuance of another government bond.

There is going to be enormous liability on the future generations that I do not think we have been providing for, and there are going to be a lot less taxpayers at that time to cover the shortage. The bills will be coming due, and that is what concerns me.

It is not so much for the next several years, but for the year 2010 and the year 2015. You even mentioned in your statement, entitlement programs offer substantial opportunities for long-term budgetary savings. But they also offer the opportunity right now, on projected growth levels under economic scenario, of having a catastrophe waiting because the money that a lot of people have the assumption is accumulating in a separate trust fund is not really there.

Dr. GREENSPAN. Well, I think, Senator, you have to distinguish between, one, the actuarial liabilities which exist for all of the various retirement funds and current obligations, which are backed up, ultimately by the tax and borrowing authority of the U.S. Government.

If social security, for example, were a private operation, the actuarial costs would be very substantial and the assets which would be employed to back up those actuarial requirements would be substantially larger than even the social security and other retirement trust funds which we are building up at the moment.

The obligations are very substantial in the public sector. The contingent obligations in an actuarial sense are very substantially in excess of any of the trust funds which we are building up.

The trust funds are being built up for the purpose of partially funding them, and they will run down after we get beyond a certain period in the early part of the 21st century.

But I think what we must distinguish is the actual liability and that part of the liability which in a sense is funded by these various different governmental trust funds. Invariably, the actual liability is much larger, so that even though we are building up these very large trust funds, it should not be assumed that we are over-funding; we are not.

Senator NICKLES. I am aware of that, and I know you are aware of that, but I think that there is a real misconception. When people have an account balance that says, yes, there is so much money in the Social Security Trust Fund and it has a surplus this year and next year it is projected to have a surplus of $46 billion—and that increases substantially for several years, but the taxpayers have that liability because all those trust funds, each one that I have mentioned, all that they have is an IOU; they have a Treasury bond that the taxpayers in the future are going to have to pay.

So, actuarily, we are not doing our job or being honest. What we could say is we are putting off a tremendous liability for the future. Those bonds are going to be coming due and our future generations are going to have to be paying for them.

And I am afraid that a lot of people are going to be running around jumping in the street, saying, look here, we have reduced the deficit, when really if you looked at the actuarial liabilities that we are stacking up for the future generations, it is just phenomenal. In my opinion, it is irresponsible.

I am a trustee of private pension plans as well and in the private sector you have fiduciary responsibility to fund for the obligations that you are incurring now so the money will be there, and we are not doing that on the Federal level and I am afraid that these trust fund surpluses or balances are used to misconstrue the size of the deficit.

I think our net operating deficit, taking out these trust funds, is actually around $240 billion, not $130, not $150 like last year's, but $240 billion. That is serious. Now, I think Congress is at fault, and I would say the administration as well. I do not think we have leveled with the people.

I think we have taken advantage of the fact that we had a very large tax increase in 1983 on social security that makes the deficit look a lot less than what it really is, and as a result we are incurring fantastic liabilities for future generations because we are spending all that money right now; we are spending it all, plus some.

Around the year 2010, I do not know who will be here. Maybe none of us will be here, but our children, or whoever, are going to be looking at that bill and they are going to be saying, "why were they so irresponsible." Why did we not have leadership coming forward, maybe from Congress or maybe from the Fed or the administration or wherever, and try and be more actuarily honest and try and not leave them with such an enormous burden? Would you agree with that?

Dr. Greenspan. I think, Senator, you are bringing up the fundamental dilemma that exists in government social insurance funds. It is a debate that has been going on for quite a while and I suspect will continue.

I would agree that there is much more to looking at the issue of the obligations of the Federal Government than strictly the question of what the actual deficit is or, more exactly, the total stock of public debt that exists out there, because we have constructed a very substantial amount of contingent liabilities which are over and above the actual outstanding public debt.

And it exists not only in this area, but in a wide variety of other areas, including deposit insurance, and all forms of governmental guarantees.

Senator Nickles. Well, the Chairman addressed that and I appreciate, Mr. Chairman, your bringing that up. Let me make just one final comment and ask for your thoughts on it very quickly, and that deals with the issue that in your statement you mentioned controlling entitlement programs as a possible area where Congress could do some good in the long term, and I would hope that we would do so.

Congress this year is in the process of expanding medicare through catastrophic health insurance, but primarily hospitalization and quite possibly drug benefits as well, which will probably be the largest expansion in the program's history.

I am concerned about not only what that will cost in 1988 or 1989, but what that will cost as well in the year 2010, and so on. I would wonder if you share that apprehension about such a large expansion of an open-ended entitlement program.

Dr. Greenspan. When one looks at the medicare program, you are caught up in a terrible dilemma in the sense that a substantial amount of the expansion in that program over and above what was originally contemplated when it was put in place, I believe, in 1968 is the result of an explosion in technology.

What has occurred is the onset of a vast new variety of techniques which are highly expensive and which are creating real increases in medical costs of a very substantial dimension.

The thing which disturbs me, basically, is that even with all of these technologies, we do not seem to have, with all of the resources we are applying, any demonstrably superior medical technology than the rest of the industrialized world. Yet, they seem to manage a much smaller percent of their GNPs for maintaining their medical programs.

And I think it would be useful to examine how it is that they are able to do it, with sometimes better longevity and morbidity rates, and the same technologies, and they seem to do it for a good deal less than we. And I think it is useful, perhaps, to understand what it is that they do that we do not if we are going to get control over our medicare trust funds and, more generally, our total and very substantial medical expenses, both public and private, as a percent of GNP relative to other countries.

Senator **Nickles**. Thank you.

Chairman **Chiles**. Senator Conrad.

Senator **Conrad**. First, just a comment. I think Senator Nickles has put his finger on something that is of concern to many of us. Baby-boomers are going to be in for a big surprise when it comes time for them to be collecting Social Security.

Many of them are under the impression we are running surpluses now in those accounts to take care of the need that will follow when they are of the age to collect. What they are going to find is a bookkeeping entry and an unfunded liability of $50 to $100 billion a year. It is going to be a big surprise.

I must say I was mystified by your earlier testimony. In the last 8 years we have tripled the national debt, and had a six-fold increase in the trade deficit. Last year we had this budget summit and virtually nothing was done to lower the deficit on a year-to-year basis.

If you take the 1987 year—even if you take previous years and look at the base—we have done virtually nothing on a year-to-year basis. As I heard your comments, you seemed to be saying, it was so tough to do anything more than that this year and we will just stick with the plan.

It would seem to me your role would be to come up here as Federal Reserve Chairman and say to us, look, you ought to do more; you ought to aggressively deal with deficit reduction this year. Just because it is an election year, you should not duck and run. Encourage us! Push us!

Let me just give you another shot by saying if you were in charge of fiscal policy, what would you do this year?

Dr. **Greenspan**. More. [Laughter.]

Senator **Conrad**. That is a good start. How much more?

Dr. **Greenspan**. I cannot conceive of, from an economic point of view, a reduction that the political system would allow which would be excessive; that is, it is not credible to me that we can reduce the deficit too much.

Senator **Conrad**. That is in line with my thinking as well, but let us be more specific. What should the goal be? What should we be trying to do this year, in your judgment? If we had the goal of wanting to achieve a more accommodative monetary policy and lower interest rates to get this economy moving again, in your judgment, what would we need to do on our side, that would be credible with you and your colleagues so that you would feel comfortable in bringing interest rates down? What would it need, $40 billion, $50 billion?

Dr. **Greenspan**. Well, first, Senator, let me just say that it is not an arbitrary action on the part of the Open Market Committee of the Federal Reserve System to make a judgment and then move interest rates.

What would happen is that the markets would bring the interest rate structure down. In other words, in conjunction with Senator Domenici's notions about real interest rates, I can tell you that if the financial markets all of a sudden became aware that there was on track a deficit reduction pattern over the longer run which was significantly lower from that which they currently perceive, then interest rates, irrespective of what the Federal Reserve would be doing, would come down.

Senator **Conrad**. Well, you are not suggesting that the Federal Reserve Open Market Committee has nothing to do with——

Dr. **Greenspan**. No; what I am basically saying, however, is that if we tried to reduce interest rates when the market was not structured in a manner to accept those reductions, then we would fail; the markets would run away from us.

Senator **Conrad**. Let me amend my question, then, and ask you what would be necessary on the fiscal side, in your judgment, to make possible lower interest rates?

Dr. **Greenspan**. I do not want to be facetious, but all I would say is more—more than the markets expect. Now, I do not know what that number is. I mean, obviously, if you took in today's environment $10 or $15 billion off the fiscal 1990 and 1991 deficit in a way that is credible, meaning not just somebody's projection, I would certainly think that is a plus.

Obviously, if you took more, it would be a bigger plus. It would have to be at least $10 or $15 billion because that is range of error.

Senator **Conrad**. So your message would be to this Congress and to this administration, do more this year, do at least $10 to $15 billion, but do not be afraid of kicking this country into a recession by deficit reduction. That is what I hear as your message.

Dr. **Greenspan**. Yes, I would say that would pretty much encompass my views.

Senator **Conrad**. Thank you, and thank you, Mr. Chairman.

Chairman **Chiles**. Senator Domenici.

Senator **Domenici**. Thank you, Mr. Chairman.

Let me follow up on one of Senator Chiles' questions. He has established that, at least your opinion, the trade situation is not going to cause inflation. You are watching it, and you do not believe that prices will rise because we are importing higher-priced goods. You are watching it, but you do not think that is going to cause inflation to go up.

I think there is a follow-on question with reference to capital investment in the manufacturing sector. In the last year manufacturing jobs have been growing dramatically and, in fact, in the last 6 months rather dramatically. I wonder if you have any way of judging whether the permanent type capital investments by the manufacturing sector are responding to this new demand in a way you would expect or are they being cautious because it is currency evaluation-prodded rather than based on something else.

Dr. **Greenspan**. There is apparently some caution. You can see it in individual investment decisions, but there is some evidence that there is a response to increased demand. We are clearly, from the equipment side, observing some fairly good new orders coming in on capital equipment.

And while we do not yet have any real flourishing evidence of so-called green field plant expansions, I think we are beginning to augment capacity in an incremental way. But I think it is certainly correct to say that we are not experiencing the type of capacity expansion boom that we have seen in past periods of American history.

Senator DOMENICI. Now, Mr. Greenspan, I wish my good friend, Senator Conrad, was still here because I do not like to contradict a Senator with my opinions when he is not present.

But, frankly, some people are running around saying let us get this deficit under control so that we can really get this American economy going—you know, I do not know what they are talking about. I mean, I do not know how getting the deficit down is going to get this economy going much better than it is already going, from the numbers I am looking at.

Maybe we could expect a little more growth. I think there is a terrible myth around that all the jobs we have produced are terrible jobs. I think that is untrue. It seems to me that the American jobs machine is working.

And I would say that there is a real evidence that the old fashioned kind of jobs are declining—in terms of expecting a plant to be built and employ people doing the same thing for 40 years. Product lines are changing very rapidly and very dramatically.

I heard testimony recently, Mr. Greenspan, that in a company like Hewlett Packard, 50 percent of their sales last year were for products that are 3 years old or younger. The 3,500 companies that are growth companies after you take out the thousand largest, I thought maybe they would be different than Hewlett Packard and I was amazed. While they are growing at 10 to 15 percent a year, 50 percent of their products last year were 5 years old or younger in terms of the product line and the product itself, which is amazing to me.

That does not mean there are bad jobs out there; it means that things are changing, and perhaps there is a lag time in training. Perhaps people have to adjust to new things.

But having said that, I do think the deficit is a drag on continued growth and a drag on future prosperity. I believe that is the case even more so if it is having a dramatic impact on real interest rates.

I think that is a real test because interest rates are a cost of doing business. In a consumer economy, it is a tremendous penalty when real interest rates are high.

Now, having said that, let me go through this with you again. We used to hear about crowding-out when we first came up here. When I came as a Senator, when this committee was established, Arthur Burns, our marvelous friend, used to sit here—and I loved him dearly; none of what I am going to say is intended as anything other than that.

He was not disposed to talk very much, to tell us very much about his plans. He gave advice about deficit reduction, as I recall, and crowding-out. Now, let me just ask, is there any evidence that there is crowding-out today? I mean, I have not heard anybody talk about that anymore.

Dr. **Greenspan**. The concept of crowding-out got overwhelmed by the new issue of supplying those savings which are needed to avert the crowding-out effect coming from abroad.

Senator **Domenici**. Right.

Dr. **Greenspan**. So the reason you do not hear it any longer is that implicit in the notion of crowding-out was a belief that there was not adequate foreign savings available to make up the gap between our domestic investment and domestic savings, and that proved to be wrong.

It may not prove to be wrong over the very long run, but it has certainly proved to be wrong in recent years and that is the cause of the demise of the concept.

Senator **Domenici**. Now, Mr. Greenspan, I am fully aware that our growing dependence upon foreign currency and foreign investment may over the long run have some policy implications that are adverse, because it may give some extraordinary control over our policy to foreign countries.

But, frankly, the availability of foreign capital is a plus that signifies that the free industrial nation concept of growth has succeeded and they have capital to invest.

There is not a crowding-out problem. Is there an inflation problem that disposes the Federal Reserve on interest rates one way or another at this point? Are you still worried about it over at the Fed or not?

Dr. **Greenspan**. We always worry about inflation, Senator.

Senator **Domenici**. Are you worried enough to keep interest rates higher because you think inflation is a problem, or do you just monitor it?

Dr. **Greenspan**. I would say that the markets essentially determine the extent to which inflation expectations create interest rate levels, especially in the long end of the market.

Senator **Domenici**. Well, what is the Federal Reserve's expectation?

Dr. **Greenspan**. Our view is that, as I indicate in my prepared testimony, in the short run that we do not expect to see a significant change in the inflation rate, but we remain vigilant because, as I said at an earlier committee hearing, we do not have all that much in the way of advance warning when it eventually comes and gets us, and we have to be very careful that it does not sneak up and bite us.

Senator **Domenici**. Incidentally, as an aside, I do not know what position you have taken on the Canadian Free Trade Agreement. I do believe, even though I have some real problems with it, that a very salutary impact in terms of potential inflation in the future will be minimized by that agreement with reference to the oil and gas security blanket that will exist, as you know, if that treaty is affirmed.

Dr. **Greenspan**. I agree with that, Senator.

Senator **Domenici**. Canada cannot charge any higher prices to us than they charge their people. So I think we have eliminated another potential for an abrupt increase in oil and gas prices.

Now, having said that, we have got inflation that does not bother you too much; crowding-out is not there. I get back to the question with reference to interest rates and money supply.

I am beginning to wonder now, for instance, do we have any arrangements that we do not know about under the G7 meetings explicit or implicit about the level of interest rates that we are going to try to maintain in the United States?

Dr. GREENSPAN. No, sir.

Senator DOMENICI. Therefore, the fact that their interest rates are substantially lower in Japan and Germany and we need their money in no way has caused us to make any private arrangements that we will keep our interest rates at a certain level to accommodate to them?

Dr. GREENSPAN. No, sir.

Senator DOMENICI. Then I repeat again, Mr. Chairman—and you were explaining it—my charts, my evaluation indicates that currently in 1988 real interest rates are higher than 1986. Now, if they are not, I would like an explanation. If they are, I wonder why.

Dr. GREENSPAN. It depends on how you measure it. I mean, as I indicated to you earlier, it really gets to the issue of the nominal long-term interest rate, if we are talking about long-term interest rates, less the expected inflation rate, which is the inflation rate expected over the full maturity of the debt instrument.

That, of necessity, is not something which is immediately available to us. I mean, it is something which market people implicitly believe, but we have no way of getting that statistic.

So we use a number of proxies to try to make a judgment of what the appropriate inflation rate is, and it depends on how one reads it. In some cases you will get a higher real interest rate than early 1986; in others you will get very little change.

Senator DOMENICI. Mr. Chairman, I wonder if you would do this for the record for us, with the Chairman's permission. Could you have your people go back and take 1986, 1987, and current 1988 and tell us, using some consistent measuring device—I do not care which one or which series, using your last answer—and tell us what the real interest rate was in 1985, 1986, 1987, and what it is currently?

Dr. GREENSPAN. What we will do is give you various different estimates because, in fact, there are different estimates.

Senator DOMENICI. Well, I understand, but I want them consistent in a column for the three periods that I have talked about so that we can see if, in fact, they have changed and which way.

Dr. GREENSPAN. Yes.

Senator DOMENICI. Can you do that for us?

Dr. GREENSPAN. Certainly.

[The following was subsequently supplied for the record by Dr. Greenspan:]

Alternative Measures of Real Interest Rates

As requested, the following tables show a number of alternative measures of real interest rates. Real interest rates are defined as nominal rates less the expected rate of inflation. Since expected inflation is not directly observable, a number of different inflation proxies are used in the tables below. The tables also present measures for Treasury securities with different maturities.

As may be seen in table 1, both measures of real 3-month Treasury bill rates generally declined from early 1985 through the middle of 1987 and have moved erratically since then. In the case of 1-year Treasury bill rates (table 2), the measures shown also indicate a decline from early 1985 to some time around the middle of 1987. After a rise in the later part of last year, all the measures suggest some easing more recently, but the contour depends on which proxy is used for inflation expectations.

For real long-term Treasury yields (table 3), some amount of upswing occurred during 1987 following 2 years of decline; these yields also have eased early this year by all measures. Real long-term yields are the most sensitive to problems in the measurement of inflation expectations and, as the table shows, the contour and overall level of real long-term rates in the past two years depend heavily on the extent and speed with which financial market participants incorporate contemporary fluctuations in inflation into their expectations. Real long-term interest rates rose very little during 1987, if as shown in column 2, inflation expectations relied more heavily on recent experience. In contrast, real long-term interest rates rose substantially, if as shown in the other columns, inflation expectations also incorporated earlier experience. Real long-term interest rates are affected the most by uncertainties of market participants about prospects for monetary and fiscal policies and, particularly last year, prospects for policies abroad and other influences on international capital flows.

Table 1

Real 3-Month Treasury Bill Rates
(Percent, coupon equivalent basis)

			Proxy for expected inflation	
			Change in CPI over preceding 12 months	Change in PCE deflator over preceding 4 quarters
1985		Jan.	4.55	
		Feb.	5.10	
	Q1	Mar.	5.19	5.23
		Apr.	4.60	
		May	4.02	
	Q2	June	3.47	4.31
		July	3.81	
		Aug.	4.06	
	Q3	Sept.	4.22	3.97
		Oct.	4.20	
		Nov.	3.92	
	Q4	Dec.	3.60	3.79
1986		Jan.	3.49	
		Feb.	4.22	
	Q1	Mar.	4.53	4.07
		Apr.	4.65	
		May	4.85	
	Q2	June	4.64	4.27
		July	4.42	
		Aug.	4.11	
	Q3	Sept.	3.60	3.64
		Oct.	3.76	
		Nov.	4.22	
	Q4	Dec.	4.59	3.83
1987		Jan.	4.03	
		Feb.	3.57	
	Q1	Mar.	2.76	2.81
		Apr.	2.09	
		May	1.94	
	Q2	June	2.14	1.74
		July	1.90	
		Aug.	2.01	
	Q3	Sept.	2.40	1.92
		Oct.	1.95	
		Nov.	1.51	
	Q4	Dec.	1.59	1.34
1988	Q1*	Jan.	2.01	2.09

*Based on information available to date.

Table 2

Real 1-year Treasury Bill Rate
(Percent, coupon equivalent basis)

			Proxy for expected inflation		
			Michigan survey*	Hoey survey*	Change in PCE deflator over preceding 4 quarters
1985		Jan.	4.90		
		Feb.	4.47		
	Q1	Mar.	5.55	3.94	6.13
		Apr.	4.13		
		May	3.75		
	Q2	June	2.79	3.89	5.06
		July	3.53		
		Aug.	4.33		
	Q3	Sept.	3.55	3.70	4.61
		Oct.	3.20		
		Nov.	3.36		
	Q4	Dec.	2.66	3.54	4.23
1986		Jan.	3.52		
		Feb.	3.91		
	Q1	Mar.	3.84	3.91	4.40
		Apr.	2.83		
		May	3.23		
	Q2	June	2.92	3.24	4.54
		July	2.55		
		Aug.	1.63		
	Q3	Sept.	2.26	2.47	3.94
		Oct.	1.91		
		Nov.	2.19		
	Q4	Dec.	1.77	2.16	4.12
1987		Jan.	1.87		
		Feb.	1.85		
	Q1	Mar.	2.42	2.05	3.04
		Apr.	2.79		
		May	2.26		
	Q2	June	2.27	2.12	2.66
		July	2.45		
		Aug.	2.49		
	Q3	Sept.	3.33	2.29	2.79
		Oct.	3.18		
		Nov.	3.05		
	Q4	Dec.	3.15	3.12	2.53
1988	Q1**	Jan.	2.57	2.29	2.58

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*Surveys of expected inflation over the following 12 months.

**Based on information available to date.

Table 3

Real Long-Term Treasury Yields
(Percent, based on 10-year constant maturity yield)

			Proxy for expected inflation			
		Hoey survey for 10-year expectations	Annual rate of change in PCE deflator for			
			4 past quarters	12 past quarters	20 past quarters	12 quarters centered[1]
1985 -	Q1	6.22	8.34	7.75	5.99	3.40
	Q2	5.34	7.42	6.96	5.50	7.73
	Q3	4.64	6.97	6.72	5.35	7.57
	Q4	4.14	6.15	6.17	5.08	6.88
1986	Q1	3.27	5.51	5.12	4.34	5.67
	Q2	2.35	5.55	4.52	3.75	4.74
	Q3	2.19	5.27	4.28	3.66	4.49
	Q4	2.16	5.59	4.38	3.81	4.39
1987	Q1	1.91	4.32	4.14	3.71	4.23
	Q2	3.05	4.27	5.17	4.81	5.29
	Q3	3.40	4.58	5.64	5.44	5.63
	Q4	3.98	4.43	5.80	5.70	5.80
1988[1]	Q1	3.12	4.23	5.06	4.96	5.11

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1. 12-quarter change in personal consumption expenditures deflator (annual rate), encompassing the 6 quarters preceding, and 5 quarters following, the quarterly interest rate. For quarters requiring forecast values, the administration's inflation forecast was used.

2. Based on information available to date.

Senator DOMENICI. My last question has to do with the investment in our country by foreign countries and the reliance upon foreign capital for our debt service. Are we at a point in terms of size and quantity of foreign capital that concerns you? If not, why not? Should there be some concern over the long run on the part of our policymakers with reference to foreign capital influences?

Dr. GREENSPAN. You mean with respect to the accumulation of foreign debt?

Senator DOMENICI. Yes, sir.

Dr. GREENSPAN. The major problem that you have when you have a very substantial debt in your domestic currency held on foreign account is that should there be a unilateral desire on the part of those holders to get out of, in this case, the dollar and into other currencies, that affects the exchange rate and interest rates, and would significantly affect economic policy in the United States.

And as a consequence of that, having a very substantial external debt—I might add that there are other problems if it is denominated in another currency—does create implications for our domestic policy actions because foreigners can affect them, whereas previously they could not do so in any substantial way.

I might also add that if we have major moves out of the dollar, if it occurs as a result of your domestic populace, you have the same effect, but the real concern is on foreign account.

We are obviously not at that point now where it is a serious concern. I am not particularly happy with the forecasts that are implicit in accumulating large current account deficits, as they imply a large increase in the debt. I would not want to say, because I do not think the evidence really supports it, that we are in a really tenuous position right at this moment. But I can conceive a number of years in the future, if we continue on this track, that we will have problems.

Senator DOMENICI. Thank you.

Chairman CHILES. Mr. Chairman, you said in reply to questions by Senator Domenici that there was no agreement in the Fed from any of the recent agreements that we have had to control interest rates or have anything to do with interest rates.

Dr. GREENSPAN. Well, no. I explicitly was answering the question, is there an agreement—he put it in terms of published or otherwise—that we have with respect to what interest rates we will try to fix, given agreements between the G7 and the participants, and the answer to that question is no.

Chairman CHILES. Well, let me just put it another way, then, and ask you is there any agreement, written or otherwise, in respect to the G7 Accords to try to hold the dollar at any level?

Dr. GREENSPAN. We basically have concluded that stability of the dollar—in fact, stability of foreign exchanges—is something that we are seeking to achieve, and that we are, in fact, coordinating our policies in a manner in which we believe that will be achieved, and that is our goal. There are no secret agreements with respect to that goal. It is pretty much spelled out.

Chairman CHILES. Well, even a spelled-out goal, implies agreements on some kind of control of interest rates, does it not?

Dr. GREENSPAN. What is agreed to is that overall policies will be coordinated in a manner to seek exchange rate stabilization. The specific, actual coordination at any specific time, I think, will depend on the conditions that exist at that time, and I would not want to say to you what would be done or what would not be done because I do not think one can effectively make those decisions until you basically understand what it is that is destabilizing exchange markets, because it is not always the same thing and it is not always the same policies that can remedy it.

And I would hesitate to suggest in advance, given a very complex situation, precisely what the appropriate responses would be to any particular international financial disturbance.

Chairman CHILES. I think you have covered yourself very carefully. But I still read your answer as being that as a result of the G7 Accords, we have put ourselves on the line in some way, morally or otherwise. We are going to try to hold the dollar at its approximate levels now, which, in effect, implies some kind of commitment towards taking steps which would include interest rates.

Dr. GREENSPAN. I cannot go beyond the statement that I made——

Chairman CHILES. I understand.

Dr. GREENSPAN. Because I think that pretty much describes the way we look at the process.

Chairman CHILES. Destabilize means, of course, to push against the tide of different market pressure, if it was there, to drive the dollar down, and therefore stability would imply tighter monetary policy if that was required.

Dr. GREENSPAN. Well, there are numbers of ways in which one can stabilize currencies, and I would not want to subscribe necessarily to any specific package in advance of the conditions which confronted us.

Chairman CHILES. I thank you for your answers, and we thank you very much for your appearance.

Senator DOMENICI. Can I have one more?

Chairman CHILES. Sure. I do not think he is trying to make any hard news here this morning.

Senator DOMENICI. No; well, we have struggled mightily to let him make some news today, have we not?

Chairman CHILES. We have, we have. Well, he has made a little—I do not think it will come out hard news, but he has made a little with me. I understand now.

Senator DOMENICI. Well, I saw reporters running out of the room, so he made some kind of news. [Laughter.]

They almost killed themselves. [Laughter.]

Chairman CHILES. I thought those were traders. I did not know they were reporters.

Senator DOMENICI. They might have been.

Chairman CHILES. I was trying to find out what they were going to buy or sell.

Senator DOMENICI. What in the world were they running for? It was your comments about inflation that really got them, in case you are wondering.

Let me just make this observation and then ask you one question. In talking about interest rates with you today, I clearly did not want to leave the impression that because interest rates have such a big impact on the Federal debt that interest rates are not very important to the small businessman, to agriculture, to the farmer, to those who produce commodities, be it copper or potash or lead or zinc, and those who manufacture high-tech products.

I mean, clearly, interest rates have a very significant impact on the well-being of all of those kinds of activities that I have just spoken of, do they not?

Dr. GREENSPAN. Yes, sir.

Senator DOMENICI. Now, let me clarify my previous statements about the American economy. I disagree with those running around saying if we can just fix this economy, everything will be fine. I think we have to fix some things because we have got to take care of the future, for sure.

But I am correct, am I not, that in spite of a general recovery and "good" new jobs in significant numbers this recovery has a parochialness to it that other recoveries did not. The oil patch is suffering, agriculture is having a difficult time, and certain product lines are having a more difficult time. Some States are not doing as well if they have those kinds of activities, as Massachusetts is with high-technology and defense spending and the like? Is that correct?

Dr. GREENSPAN. It is certainly the case that the growth or economic development amongst the States is uneven. It is always uneven. The interesting thing that the data show is that while this has been rather unusual with the oil and the agricultural State difficulties, it is not an outlier, so to speak.

I mean, if you go back in any of the periods in American history, especially in the post-World War II period, there is a remarkable divergence amongst various areas of the country, some going up, some not, and it is one of the extraordinary strengths of our country, in that we sort of arbitrage the various different areas of the country.

In a sense, it is sort of an indication as to what the implications of free trade really mean, because we have no barriers between our States, and when we have difficulties in various areas of our country we get migration going in and out, jobs moving in and out, and it is a self-adjusting process so that the divergences are significantly limited.

Having said that, there is no question that this is one of the more extraordinary periods when some areas of the economy are doing exceptionally well and others are doing exceptionally poorly.

Senator DOMENICI. Thank you very much. Thank you, Mr. Chairman.

Chairman CHILES. Dr. Greenspan, we are always delighted to have you before this committee, and you have not disappointed us at all in your appearance now as Chairman of the Fed.

Dr. GREENSPAN. Thank you very much, Mr. Chairman.

Senator DOMENICI. Thank you.

[Whereupon, at 12:05 p.m., the committee was adjourned.]

THE TAX GAP

THURSDAY, MARCH 31, 1988

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Lautenberg, Conrad, Domenici, and Nickles.

Staff present: Richard N. Brandon, staff director; and Jim Carr, assistant director for tax policy and credit.

For the minority: G. William Hoagland, staff director; and Cheri Reidy, economist and senior analyst for revenues.

Chairman CHILES. This morning the committee will examine the tax gap, the difference between what the Internal Revenue Service believes taxpayers owe and what's collected.

With us today are the Commissioner of the Internal Revenue Service, Mr. Lawrence Gibbs, former IRS Commissioners Donald Alexander and Jerome Kurtz, and Jennie Stathis, an Associate Director of the General Accounting Office.

Congressman Dorgan is also here to testify today.

OPENING STATEMENT OF CHAIRMAN CHILES

IRS estimates tell us that between 1972 and 1986, the amount of taxes owed but not paid group from some $28 billion to $96 billion. In an effort to recapture those funds and help in reducing the Federal deficit, Congress has provided IRS with money to improve enforcement in tax collection.

There are some problems. For one thing, IRS has been faced with the prospect of hiring thousands of additional revenue agents. It hasn't been easy to find them, and once they're found, they have to be trained. All that takes time.

Second, Congress has counted on substantial additional revenues as a result of the collection program. If the program isn't on schedule, the collections will be slower and the deficit will not decline at the rate expected.

Now, we come to problem No. 3. The IRS tell us, with the extra money Congress has provided, they have taken in more revenue than anticipated. The only trouble is IRS doesn't have a dependable way of measuring how much more money it's collecting as a result of the money it's spending on collections. In fact, the actual tax gap is expected to keep growing for the foreseeable future.

And there's another thing. The IRS claims that collections go up when taxes are less complex. Because of tax reform, things are supposed to be more simple and, therefore, more money will be collected.

I don't know how many in this room have done their taxes so far, but if we're counting on simplicity to produce more revenue, the country is going to be broke by August.

It seems to me all these ideas about increased collections rest on the assumption that it's possible to predict human behavior. Having been in Congress a long time, I think if anybody thinks they can guess what people will do, they're likely to make more money in Las Vegas than in Washington.

I don't mean to be flip about the serious effort to collect taxes owed. It holds out the possibility for a way to further reduce the deficit. Just as important, it's a way to bolster the commitment of the American citizens to pay their fair taxes.

Where we've got to be careful is that we don't overestimate what the program can do. And we've got to have an accurate way to measure new collections. We've got to have enough trained people to make sure these collections come in.

Our witnesses this morning are seasoned veterans of one of the most crucial and complex areas in the life of the country. We look forward to your testimony and hope that you can help us get a more solid grip on the tax gap.

We'll call on Congressman Dorgan first. I understand he has another committee meeting in the House.

Congressman, we know of your activities in this regard and the leadership role you play in this area in the House. We are delighted that you would take the time to come over and testify before us today.

STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. Dorgan. Mr. Chairman, thank you very much for recognizing me. We have a Ways and Means hearing ongoing that I have to return to.

I'd like to submit a complete statement for the record and simply summarize my remarks.

Chairman Chiles. Without objection, that will be placed in the record.[1]

Mr. Dorgan. This country has a very serious budget problem with a significant Federal budget deficit, and that occurs, not because of the tax gap, but that occurs, in my judgment, because of consciously foolish fiscal policy constructed over a long period of time.

But we have a tax gap or, that is, a difference between what we should collect in income tax and what we actually collect. It is significant enough so that if we were to do something serious to address this tax gap, we could, at the same time, significantly improve our deficit picture. And that's why I think the tax gap is important at the moment.

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[1] See p. 298.

It's important in the long term simply because if we have a revenue system, we ought to do all that we can to make certain that it's administered fairly.

The last 10 to 20 years, tax avoidance and tax evasion have become, at least in some circles of this country, a type of a game. In the last 6 or 8 years, the growth industry in America was the tax shelter industry. You can't name for me, at least, more significant growth of any enterprise in America between 1980 and 1986 than the tax shelter industry.

That's changed somewhat since the tax reform bill. But the entire public mood and climate surrounding our tax system in the last 10 or 15 years has promoted a kind of an expectation that people will fudge a little, or some people will cheat, or some people will do whatever is necessary to avoid taxes. When I say some, I'm talking about a relatively small portion of the population. The majority of the people out there pay taxes, pay them willingly, pay them on time, and pay what they owe.

We do have some people who refuse to do so, and they're the freeloaders in our society. That's the tax gap.

It seems to me that those who pay their fair share and do so willingly and honestly should expect those of us in public policy to do what we can to make sure the others who are not paying nearly $85 billion a year are discovered and made to pay their fair share as well.

I, like Senator Conrad, have a background in State taxation and have a natural interest in the area of tax compliance.

Last year, I put together a task force comprised of, I think, the best minds in Washington, DC, including a former Republican Internal Revenue Service Commissioner, a former Internal Revenue Service Commissioner under a Democratic administration, a former head of the Joint Tax Committee. I am talking about some of the best people in town including former Treasury officials. The task force studied the taxgap during a series of meetings over 6 or 8 months and developed an analysis of what it is and what kind of serious recommendations could be put together to address it.

We came up with a series of recommendations in the enforcement and taxpayer assistance areas that we think would narrow the tax gap, raise some additional revenue for the Federal Government, and address this problem as we should address it on behalf of all the honest taxpayers in America.

There are some people who are skeptical of any effort, no matter how noble the effort and, no matter how skilled those who put the recommendations together. They're skeptical because, frankly, some folks on the Budget and Tax Committees who have been around here for years have responded to the need for a few extra billion dollars by saying let's throw in some enforcement revenue. And so they plug in $2 billion of revenue that they need to match something in the budget, and they say we'll just call this better enforcement. It's really been halfway fraudulent frankly. That's been going on for years around here.

Chairman CHILES. Kind of like finding waste, fraud and abuse.

Mr. DORGAN. Yes, pretty much in the same category, and the fight really is on paper, and it takes you as long as it does to put it on the paper, and then it's all over. And we've done that with better enforcement several times in the 1980s. That's why I think some people are skeptical, when others say, there's a way to increase compliance and narrow the tax gap. They say, now, is this the same old thing that we've heard about before? We're going to raise more money by attempting to provide better enforcement? No; it's not the same thing. This is real.

Let me tell you what this task force comprised of: IRS Commissioners of Republican and Democratic Administrations and the other experts in town put together. A two-pronged approach that says, number one, we need better enforcement. That means we need to restore the number of audits in our tax system. We used to audit 2½ percent of the returns. That fell to around 1.1 percent of the returns. Clearly that has to have an impact. We need to restore the number of audits, we need to restore the effort in collections, we need to restore the resources in a whole series of enforcement areas.

But, second, and just as important, we also need to beef up taxpayer assistance. We need to put the service back in the Internal Revenue Service. We need to extend a helping hand to the taxpayers who face an increasingly complicated tax system.

In my part of the country in North Dakota, which is a relatively rural area, you don't see much of the IRS any more. And that's because, over the years, it's become more centralized. First, it was centralized to Fargo, then centralized to Minneapolis-St. Paul. The contact largely is picking up the telephone and getting a busy signal if it's in the busy time of the year.

The recommendations are to move the IRS back out in the country again, a program called "IRS Across America," where we send a message to the American people, that, we understand the tax system, and that in order to be fair, it's not going to be as simple as everybody would like it, but we're going to extend a helping hand to help you comply. It should not take a Herculean effort to find somebody with the IRS.

We're going to, in this program "IRS Across America," move the Internal Revenue Service back out into the country during tax seasons and extend a helping hand to the taxpayers.

The point is that if we have compliance at around 81 percent, and that's 18–19 percent non-compliance, if we increase that by 1 percent a year through a series of programs that better enforce and better assist the taxpayers and tax laws, if we do that, we can pick up significant amounts of new money. Our estimate is we could pick up $7 billion for each percentage point that we improved in the compliance area.

If you and I were running a corporation, and we were losing 15-20 percent of our revenue through the cracks, we'd call in the best executives we had, and we'd say, look, we've got a problem, we need to put together a program to try and find out how we catch some of that revenue. That's what we need to do here in Congress. You're going to hear from former Commissioner Kurtz and former Commissioner Alexander, who were co-chairs of this task force, and helped establish a set of comprehensive recommendations that we think really address this problem.

Again, we're never going to get the tax gap down to zero. I understand that. This tax gap incidently is without measuring the illegal economy or the so-called cash society. We're never going to get that down to zero, but we can, through better management do a much better job than we are now doing.

Let me say also that you're going to hear from Commissioner Gibbs for whom I have the greatest respect. I think the Internal Revenue Service is back on track. It had some tough times in the 1980s, but Commissioner Gibbs, has his heart in the right place, he's a skilled administrator and, I think, would like to do what most of us would like to do, and that is to put together the right kind of programs to narrow this tax gap, get the folks who are the freeloaders to begin paying taxes so that the rest of the folks who are the honest taxpayers in this country understand the others are going to help reduce the Federal deficit.

I have a good deal more in my prepared statement, Mr. Chairman. I'd be happy to answer any questions.

Chairman CHILES. Thank you, sir.

[The prepared statement of Mr. Dorgan follows:]

TESTIMONY OF
THE HONORABLE BYRON L. DORGAN
BEFORE THE SENATE COMMITTEE ON THE BUDGET

ON

THE TAX GAP

March 31, 1988

Mr. Chairman, thank you for providing me the opportunity to testify before the Senate Budget Committee on the tax gap. The tax gap represents the difference between federal income tax liability and actual federal income taxes voluntarily paid. It does not include unpaid income tax liability from the illegal economy nor does it include evasion of other federal taxes such as excise and employee taxes. Most simply stated, the tax gap represents the amount of income taxes which are legally owed but are not voluntarily paid.

Just two weeks ago, the Internal Revenue Service released new estimates of the tax gap. According to these projections, the tax gap for 1987 is $84.9 billion, $63.5 billion of which is attributable to individuals and $21.4 billion of which is attributable to corporations. The tax gap is projected to increase to over $100 billion by 1991. These are truly alarming figures. As we in Congress struggle with the federal budget deficit and desperately search for critical sources of revenue, we would be remiss if we did not take a very serious look at means to narrow the tax gap. Further, a tax gap of this magnitude is morally unacceptable since the millions of taxpayers who honestly and completely fulfill their tax obligations must bear the burden for those who evade their own liability. For these reasons, I applaud you, Mr. Chairman, and the other members of the Committee for holding these hearings.

In 1987, I formed a bipartisan task force to examine the causes for the tax gap and to develop a five year plan for its narrowing. This task force was co-chaired by former IRS Commissioners Donald Alexander and Jerome Kurtz. It included a number of respected authorities on tax administration and policy from both the public and private sectors. The task force report, which was released nearly a year ago, makes a series of recommendations that, if enacted, would raise $7 billion in the first year and a total of $105 billion over five years.

In a voluntary federal tax system as we have in this country, the tax gap can only be narrowed by increasing the voluntary compliance rate. The current voluntary compliance rate has been estimated to be in the range of 82% to 85%. Assuming the more optimistic estimate, nearly 15% of the tax liabilities remain unpaid. The most effective means of increasing voluntary compliance is through a balanced approach of both increased enforcement and increased taxpayer assistance.

In 1976, the IRS audit rate was 2.5%. By 1986, that figure had dropped to 1.14%. Admittedly, the rate decreased in part due to the concentration of resources on larger, more complex returns. But, the fact remains that if the taxpayer is reasonably secure that he or she will not be caught, their motivation to honestly comply is correspondingly reduced. By increasing the audit rate, not only are revenues directly raised through assessments, interest and penalties but also a far greater benefit occurs due to the increased voluntary compliance. Congress and the Administration should establish a goal of re-attaining a 2.5% examination rate within five years. But, if we are to increase the number of audits, it would be foolish to do so without a corresponding increase in IRS resources for appeals and litigation and collection of accounts receivable. To do otherwise would be to merely create a bottleneck in our system of revenue enforcement and no significant revenue gain would be realized.

While I feel there is a great need for increased enforcement at the IRS, I strongly believe that it must be coupled with improved taxpayer assistance. To solely focus on the one while ignoring the other would undermine the goals recommended by the task force. At times, some here in Washington look for the quick and easy solution. Enforcement may appear to raise immediate revenue, but only when matched with better assistance and improved access to the IRS, will the voluntary compliance rate truly begin to improve.

The 1986 Tax Reform Act, and other tax legislation enacted during the 1980's, has left honest taxpayers genuinely confused and uncertain. There are many taxpayers who want to meet their obligations but need guidance. My task force recommends a program called "IRS Assistance Across America" that would take IRS back into the towns and communities throughout the country. Through the use of "taxmobiles," "tax fairs" and other creative approaches, honest taxpayers would be able to get the help they need. Further, the IRS presence in the community would have a positive impact on taxpayers' sense of obligation to comply. Further, I believe the IRS needs to expand and improve taxpayer assistance and education programs. Telephone service and accuracy must be upgraded and the IRS must be provided with the necessary resources to promptly respond to mail inquiries. In short, the IRS must receive the necessary resources to provide a comprehensive taxpayer assistance program and then must effectively implement that program.

It is clear that the tax gap represents a considerable source of critically needed revenue and I believe studies, such as that produced by my task force, illustrate that a significant portion of those revenues can be collected through effective assistance and enforcement programs. But, in the current budgetary process, we are heavily dependent on revenue estimates. Frankly, if a proposal has merit as a matter of policy and it is agreed that it would raise revenue, but if that revenue cannot be quantified to the satisfaction of an unknown revenue estimator, then the proposal must fail. To measure the full benefits of a program to narrow the tax gap, the fact that improved assistance and increased enforcement will have behavioral consequences must be taken into account. To claim that better taxpayer assistance will not result in any revenue is patently absurd. To claim that it does raise revenue but that it cannot be measured is equally ludicrous. Virtually all revenue estimates take into account the effect the changes in law will have on behavior. If so in other areas of the law, why not in tax compliance? If the necessary data is incomplete, we should begin to acquire that data. I urge this committee to work with its House counterpart, the Ways and

Means and Finance Committees and the Administration to develop a method of measuring the effect of improved IRS assistance and enforcement on the voluntary compliance rate. It is clear that improved compliance will raise necessary revenue and could be an integral component in a deficit reduction plan.

Thank you again for inviting me to testify this morning, Mr. Chairman.

Chairman CHILES. You told us that you calculate that an additional $7 billion could be generated by increasing the compliance rate by 1 percent. And also I think you say in your statement that increasing compliance by 1 percent a year from 1988 through 1992, would generate additional revenue of $105 billion. That would help an awful lot when we're looking at our budget.

How do you calculate that revenue gain?

Mr. DORGAN. Well, Mr. Chairman, the calculation of the revenue gain is a calculation that, as I recall, came from the Internal Revenue Service's estimates of the tax gap and the compliance rate. It is what narrowing the compliance rate by 1 percent, or in this case 5 percent over 5 years, would yield in a comparable period of time.

Chairman CHILES. Well, we thank you for the work that you're doing in this regard.

Do you have any questions, Senator Domenici?

Senator DOMENICI. I just have one.

In the Appropriations Subcommittee that funds IRS, we have had the opportunity to talk with the Commissioner about implementation of the Enforcement Act that we adopted year before last and into which we have placed substantial new funds.

One issue that came up, is the growing problem of available qualified applicants for various technical and professional positions with IRS. I think we all knew that, for a long time in history, IRS jobs were very cherished by the legal and accounting professions. Whenever you had a hundred job openings for lawyers, you got 700 or 800 darn good graduates applying. And you had a good crop of new graduates always there for many years. In fact, you probably know that some of the great professionals that stayed at IRS 20 or 30 years in the Legal Department became absolutely America's experts in tax law. In spite of the clamor to get out to the private sector and make more money, many of them stayed.

I am told that they are having a very difficult job, even though we gave them more money, filling the slots in a timely manner with qualified people.

Did you also find that in your study? How significant is the problem in a newer and broader helping hand enforcement combination?

Mr. DORGAN. I think there is a problem. I don't think it's insurmountable. I think the issue here is the will. If there's the will to broaden our enforcement and our assistance efforts, we will get that done in a timely manner.

There's no question that when you're attempting to broaden your audit capability over a short period of time, they're going to run into some supply/demand difficulties.

I was listening to a friend of mine the other day on a little panel I served on, and he characterized this whole thing, as some do, as an attempt to go hire a thousand music majors from Texas A&M, and send them out across America to audit somebody. You know, there are a lot of folks who trivialize both the enforcement and the taxpayer assistance side of this.

I want to make sure that you understand that, in my judgment, the taxpayer assistance side is as every bit as important as the enforcement side. One of the problems we've had in this town is that there are not very many people who believe that if you invest a dollar in assistance that it will yield additional revenue to the government. I think they are dead wrong.

We have had a problem in years past with the administration who says a dollar of assistance is a dollar just thrown away. The fact is, a dollar of taxpayer assistance to help the American people comply with an increasingly complex income tax system is a dollar that will come back many times in my judgment.

So I want to emphasize, and I think Commissioner Kurtz and Commissioner Alexander will too, that taxpayer assistance is something that's critically important. We need to find a way to score for budget purposes what we're doing in enforcement and assistance. If you look around at OMB, Treasury and others, including the IRS, you won't find an adequate mechanism to begin scoring what we're trying to do here. That's a real problem. I think Commissioner Gibbs knows that, the Treasury Secretary knows that, and OMB does, and we're beginning to try and sift through the problem.

Senator DOMENICI. What do you mean by use of the word "score" there?

Mr. DORGAN. Well, I'm talking about scoring for budget purposes. If we did what we recommended should be done in this tax gap task force, and attempted both an enforcement and an assistance programs, and in fact succeeded in raising that money, the money that we invested in better taxpayer assistance in the IRS "Across America Program" to help the taxpayers comply would, at least under today's scheme of things, be considered a net loss by those who judge these things. They see taxpayer assistance as just moving money out to get spent but you get no return for it. They believe that you only get return if you invest in enforcement.

You do get return if you invest in enforcement, but it's just as important, at the same time, to invest in taxpayer assistance which also gives you a return. When I've talked about scoring, I'm talking about a Budget Committee or an Appropriations Subcommittee, which puts money in to do this, and then analyze: What do we get for the investment? Some say, that if you do it in the assistance area, you don't get anything and you just lose the money. That's sort of the prevailing mind set these days, and that's a problem for us.

Senator DOMENICI. Mr. Chairman, I have trouble with it. I agree with Mr. Dorgan's theory totally. As a matter of fact, I agree with it on the basis that you cannot dramatically enhance enforcement on the American people and succeed without having the taxpayer assistance program. You just cannot continue to accelerate enforcement unless you are, at the same time, giving the impression that you're interested in the taxpayers problems. But I don't know that I could quantify this one either. I would say we ought to do it.

You say "score it." I don't know where we will find somebody who will tell us what the numbers are. They will tell us the numbers on the enforcement side.

You put money into the assistance program. Are we to say, OK, experts have told us it yields a return, so we score a return. Where do we find the empirical evidence to put on this type of ledger? We can invent it, and say experts are telling us it is. But how are we going to find the number to score as a return?

Mr. DORGAN. I don't think you have to invent it. I think just common sense suggests that those who suggest that investments in taxpayer assistance is a net loss are just wrong,

Frankly, as you know having been involved in the Budget Committee over here so long, you know there's an expert who will tell you almost anything in this town, no matter how bizarre it is,

Senator DOMENICI. Absolutely.

Mr. DORGAN. In this area, the combination of enforcement and taxpayer assistance, in my judgment, invested the right way can yield significant new returns to the Federal Government, and those returns come from the people who are not now paying their fair share.

This is not imposing more burdens on the honest taxpayer. Those folks pay their taxes. They file their returns and they comply with the law. These enforcement efforts are directed at folks who are not now complying with their honest responsibility to the Federal Government.

Chairman CHILES. Senator Conrad.

Senator CONRAD. I want to welcome Congressman Dorgan. I think he's another example of how smart these former Tax Commissioners from North Dakota really are. [Laughter.]

As the Chairman knows, Byron Dorgan preceded me as Tax Commissioner of North Dakota. I was his assistant for 6 years, and then I became Commissioner when he came to Congress. And we worked very closely on these issues in our State.

And I think what we really need to drive home and emphasize is that we're talking about a package here. We're not talking about just going out and enforcing the law. We're talking about doing that but in conjunction with the increased service to the American taxpayer and, believe me, that's desperately needed.

I watched, as State Tax Commissioner, as the IRS receded from its traditional role of providing service, and that created enormous problems. I think Congressman Dorgan can verify that.

But, beyond that, I think we're also talking about telling a story to the American people., It's a true story, it's a story about what needs to be done and what can be done that will be of assistance to the honest taxpayer. And, Congressman Dorgan, I'd like to get your reaction. We know that the vast majority of taxpayers in this country are paying what they owe, what they legitimately owe. We've got a few that are not.

Those few, in percentage terms, turn out to be a lot of folks, and we should include the corporations here as well. And its very disturbing to see that the rate of audit has fallen very sharply in this country. Mr. Chairman, just for the record, I think we should indicate, in 1964, the audit rate on individuals was 5.1 percent; on corporations, it was 13.5 percent. In 1987, those rates had fallen to 1.2 percent on individuals; 2.1 percent on corporations. So we have seen a dramatic fall-off in enforcement in this country to assure the honest taxpayers who are paying what they owe, that the others who may not be so honest are paying what they owe.

And, again, I just ask Congressman Dorgan, we're really talking about a package here, aren't we?

Mr. DORGAN. Yes, and that's what's important to understand. As background, the problem is on the House side as well, I'm not suggesting it's just on the Senate side. Every time somebody wanted a little more money and couldn't figure out where else to get it they pulled it out of the air and called it tax enforcement. That ruined the climate here for a serious discussion about the kind of issues we're talking about today.

As testimony will reveal later in the day, the tax gap is in the upper $80 billions and it's going to grow to $105 billion very quickly. The difference between what the tax gap was estimated to be and what it is now estimated to be, $105 was estimated in 1983, and now around the upper eighties, is simply a difference in the method of computation rather than any substantial change in the gap itself.

If we're going to address it, and we certainly should if we're responsible, then it seems to me the procedures to address it are twofold: enforcement and assistance I would not support any kind of a massive enforcement program that imposes additional burdens on the shoulders of the taxpayers out there already complying.

One of the other points I want to leave you with is that this year is the first year in which people are preparing their tax returns as a result of the 1986 Reform Act. Senator Chiles indicated that it is not simple, and that understates the case.

For millions who will file the short form now, who filed the long form previously, it will be simpler. But for many, many more in this country will confront a long form that is different, and in many cases confront a long form that is enormously complicated, even in the home interest deduction and several other areas.

We are moving not towards simplicity but towards complexity, and it's something we've got to solve. Even as we begin to try and solve that, we have to hold out the helping hand to the IRS, to the taxpayers, to say we want to help you comply with the tax law. That's our responsibility in my judgment.

Senator Conrad. Mr. Chairman, if I just might, ask this followup. As Congressman Dorgan knows, in 1981, I convinced the North Dakota Legislature to start what we called a fair share program. It was a program to invest in compliance and enforcement, and we got $14 for every dollar that we invested in that program. We got $14 in the bank. These weren't audit dollars; these weren't estimates; these were hard dollar collections for every dollar invested.

Congressman Dorgan has played a leading role on the House side on this issue at the national level, and was an aggressive administrator at the State level. I think we know from our own firsthand experience in North Dakota that these things really work.

And when we look at what's happened to the tax gap, we find an absolute explosion in what is owed and not being paid. We've gone from $28 billion in 1973 of tax gap to a figure in 1986 of close to $100 billion. And another piece of objective evidence that supports the work of Congressman Dorgan's task force is a study the California Institute of Technology issued last year. This study concluded that if we had just retained the audit rates in 1985 that we had in 1977, we would have collected $47 billion more in revenue in 1985: $47 billion more if we had had audit rates of 2.3 percent on individuals and 9.5 percent on corporations. And even those audit rates are much lower than we had in 1964.

And so again I want to thank Congressman Dorgan for the leadership he's shown on the House side, putting together the task force. I think the work of that commission has been verified by the California Institute of Technology study.

Any comment that you'd like to make on the California Institute of Technology study and how that might confirm the work of your group?

Mr. DORGAN. As you say, I think it's self-evident that, given what's happened to the tax system and the diminution of enforcement over the years, it's serious improvements that we might make are going to yield us significant revenue.

I am hopeful that this Budget Committee is taking a good look at this. I've had inquiries from your staff over the months since this task force released its report. It is my hope to continue to see this kind of interest in the subject, Mr. Chairman, because I think it is a serious topic that we must address. It will only happen if someone like this panel or a similar panel in the House takes it, and says we're going to do something about this.

Chairman CHILES. We thank you very much for your statement and your testimony. And I want to just observe that I think you're a man of great political courage and faith if you're going to be responsible for returning the IRS agents to North Dakota. [Laughter.]

Mr. DORGAN. Well, we want them all to buy a house. We're talking about a permanent move. [Laughter.]

Chairman CHILES. We all remember the adage, "I'm your friendly IRS agent, I'm here to help you." [Laughter.]

Senator CONRAD. Mr. Chairman, if I could follow up on that point, I think it's an important one because we get some impressions from our colleagues that, gee, this is politically dangerous. Not at all. Congressman Dorgan, when he was tax commissioner, got reelected with 79 percent of the vote being an aggressive administrator. I was reelected with 79 percent of the vote after instituting the fair share program in North Dakota. And I think you'll find the overwhelming majority of taxpayers who do pay what they owe welcome knowing that those who aren't paying are being asked to come forward and pay what they owe.

Thank you, Congressman Dorgan.

[The prepared statement of Senator Conrad follows:]

Senator Kent Conrad

Opening Remarks

Senate Budget Committee

March 31, 1988

Mr. Chairman, as this Committee well knows, I have a strong and long-standing interest in the potential for improving Federal tax compliance. Prior to my election to the Senate, I served for six years as North Dakota's Tax Commissioner. I am convinced that a comprehensive effort to upgrade Federal tax enforcement could build upon the successes we've seen at the state level--and produce substantial additional revenues for years to come.

Today's hearing is particularly timely. Two weeks ago, the Internal Revenue Service released new figures showing that the Federal tax gap had narrowed, to about $85 billion in 1987, as compared with the level of $115 billion projected for that year back in 1983. The new numbers should not be treated with complacency, however. The tax gap shot up--from $28 billion in 1973 to $95 billion in 1986, as voluntary compliance deteriorated. Even by the latest estimates, the tax gap is still very large--and will continue to grow to $114 billion in four years. Much of this revenue is collectible, and it's truly an affront to honest taxpayers if we do not try.

Over the last two decades, audit rates in all major taxpayer categories have steadily plummeted. In 1964, the audit rate for individuals was 5.1 per cent, as compared with 1.2 per cent by 1987. The audit rate for corporate returns dropped from 13.5 per cent to 2.1 per cent in the same period of time. According to a study issued by the California Institute of Technology last year, if the 1977 audit rates (2.3 per cent for individuals and 9.5 per cent for corporations) had been maintained, the IRS would have collected an additional $47 billion of revenue in 1985. Meanwhile, rapid increases in accounts receivable--which reached $56 billion at the end of last year--justify more resources for collections as well.

In fiscal 1988, the Internal Revenue Service received an increase of more than $600 million, to permit implementation of the second installment of a multi-year plan to improve compliance. Among other features, the initiative called for hiring 2,500 examiners and 3,000 new collections personnel a year. The Administration did not request additional funds in the fiscal 1989 budget request for IRS, even though the agency calculates that each dollar spent on examinations produces $15 of additional revenue, while each dollar spent on collections produces $20. With the prospect of returns like these, why shouldn't the effort be made?

Improved enforcement--important as that it--is not the whole answer to our compliance problems. Better taxpayer service is vital, particularly now. As taxpayers struggle to cope with the major changes and complexity of the 1986 tax law, the benefits of providing prompt, accurate, and courteous service cannot be overstated.

Last year, a task force headed by my colleague Byron Dorgan, on which the two former commissioners with us today both served, issued a report on how to reduce the Federal tax gap. It outlined a thorough, balanced approach to upgrading enforcement and taxpayer service over a period of five years, aimed at raising the voluntary compliance rate by one percentage point per year. These recommendations deserve our full and enthusiastic support. As we saw in North Dakota, this kind of investment will permanently improve the level of compliance--and help to assure that everyone pays a fair share of taxes.

The Committee will hear today from the leading experts on this subject: Congressman Byron Dorgan; IRS Commmissioner Lawrence Gibbs; Jerome Kurtz, who served as commissioner from 1977-80; Donald Alexander, who served as commissioner from 1973-1977; and Jennie Stathis, Deputy Director at the General Accounting Office. I am eager to hear your testimony--and know we shall benefit from your advice.

Chairman CHILES. We'll now hear from a panel of experts. Commissioner Gibbs, if you would come to the table, and our former Commissioners, Mr. Alexander, and Mr. Kurtz and Ms. Stathis from the General Accounting Office.

We'll let you lead off, Commissioner Gibbs.

STATEMENT OF HON. LAWRENCE B. GIBBS, COMMISSIONER, INTERNAL REVENUE SERVICE

Commissioner GIBBS. Thank you, Mr. Chairman.

Good morning.

Chairman CHILES. Good morning.

Commissioner GIBBS. It's a pleasure to appear before this committee for the first time. And I am particularly happy that this morning we can discuss the subject of the gross income tax gap that we have in this country.

Chairman CHILES. I hope you'll note, Commissioner, and Mr. Kurtz and Mr. Alexander, we're not asking any of you to fill out any form before you testify here. We're not waiving any rights. [Laughter.]

Mr. ALEXANDER. Thank you, Mr. Chairman.

Commissioner GIBBS. Two weeks ago, the Internal Revenue Service issued its latest report on the size and composition of the gross income tax gap. That report contained good news and bad news. The good news, we believe, is that the gross income tax gap for 1987 has declined from our previous estimates and that voluntary compliance for individuals is improving. The bad news, is that the tax gap is still at an unacceptably high level, and is actually expected to increase through 1992.

In 1983, we had estimated that the gross income tax gap for 1987 would be about $115 billion. Since that time, we have had several major tax bills, including the Tax Reform Act of 1986, which have made significant changes which have helped to reduce the gap and improve compliance by individual taxpayers.

We also have developed new data since the time of our last study, and we have improved our methods of estimating the tax gap. Our most recent analysis, published 2 weeks ago, estimates that the gross income tax gap for 1987 is approximately $85 billion.

We also project an improved rate of voluntary compliance for individual taxpayers through 1992. However, we estimate economic expansion and inflation will cause the size of the tax gap to grow to nearly $114 billion by 1992. Accordingly, we at the Internal Revenue Service will need to continue an effective use of our resources to promote voluntary compliance, not only, as the discussion has indicated, through enforcement, but also through our taxpayer service activities which are necessary to ensure the confidence of taxpayers in our system.

In my testimony today, I would like to do three things. I would like to define the tax gap and identify the types of taxes and economic activities that are included in our estimates and those that are not.

The second thing I'd like to do is to highlight the key features of our estimates, both for individuals and for corporations.

And third, and finally, I'd like to explain why our estimates are now lower for 1987 than those published in 1983.

Initially, I'd like to make two important points. First, our estimates of the income tax gap are just that, they are estimates. They are developed with a high degree of professionalism and with the best data that we have available. But, by their very nature, they are subject to greater variation than are most estimates.

Particularly, our estimates for corporations are subject to more uncertainty than those for individuals.

The second point I would like to make is that our estimates are measures of noncompliance. They are not measures of the potential for additional enforcement yields because they are made up of three different and distinct aspects.

First, the gap is composed of amounts which are eventually collected through our current enforcement activities. And that reduces the gross tax gap to what we call the net tax gap.

The second component of the tax gap are amounts that are not presently collected through enforcement, but it would be cost-effective to do so.

The third element of the tax gap are amounts that are not collected through current enforcement and we believe, at the present time, it would not be cost-effective to do so.

Specific estimates of the relative size of each of these three components will be available later this year.

Because it would not be cost-effective to attempt to totally eliminate the tax gap through enforcement, we believe that Congress and the Administration should continue to look to the data on enforcement program yields in the context of our budget process.

I would now like to move into a definition of the tax gap itself. We define the tax gap as the amount of income tax owed but not voluntarily paid. Let me elaborate on this definition a little bit in order to explain.

The first point I would make is that we are talking here about income taxes, both individual and corporate. Other types of tax, employment tax, excise tax, estate and gift tax are not included in our estimate.

The second point that I would make is that when we talk about taxes voluntarily paid, we mean taxes that are paid without IRS enforcement action. Through enforcement, we do assess and collect part of what taxpayers owe but do not voluntarily pay. And therefore, as I indicated, we do close the gross gap to a net gap with our enforcement activities.

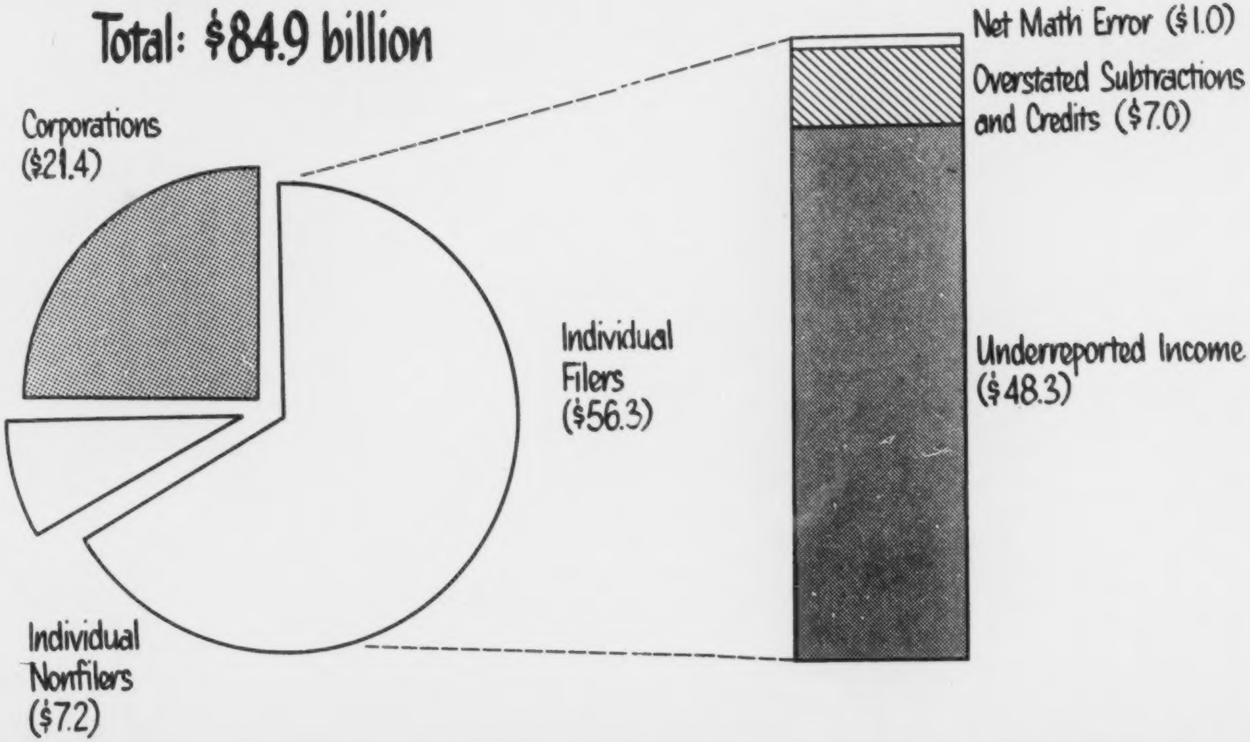
As I mentioned previously, estimates of the net tax gap that remains after our enforcement actions are currently being developed and we will be providing those later this year.

Finally I would point out that our estimates account for noncompliance in the regular economy and also the legal sector of what we have come to call the underground economy, such as the income produced by sidewalk vendors and moonlighting.

I would also point out, however, that it does not include income from the illegal segment of the so-called underground economy, such as income from gambling, narcotics or prostitution. The reason is because of the difficulty that we have in attempting to measure and tax that type of income.

I'd like to call your attention to the first chart that we have because it does, I think, help to explain and understand the revised estimates of the gross tax gap for tax year 1987. That gap, as you will see, consists of $63.5 billion attributable to individuals, and $21.4 billion for corporations. So the way the gap breaks down is approximately 75 percent attributable to a gap in the compliance by individuals, and 25 percent attributable to a gap in compliance by corporations.

Revised Estimates of the Gross Tax Gap (in billions), Tax Year 1987



Let me turn now to the individual tax gap and take you through it. I'll direct your attention to the chart, and explain it as we go through so you can understand the features of the gap. I think it may help our discussions today.

Individuals who do not file required tax returns account for approximately $7.2 billion of the tax gap. Those are the non-filers. The individuals who do file but do so inaccurately account for about $56.3 billion. The tax gap for individual filers, those that file, is due to either underreported income or overstated subtractions, such as deductions, exemptions, and credits, or math errors on the returns, or a combination of those. That's basically what makes up the gap attributable to individuals who file their returns.

By far the largest part of the tax gap, about $48 billion, or about 57 percent of the gap, relates to individual taxpayers who file returns but who understate their income. About 17 billion of understated income is attributable to understated non-farm business income of self-employed individuals.

Chairman CHILES. Are we talking about people just dealing in cash now?

Commissioner GIBBS. No, we're really not, Mr. Chairman. We're really talking about—and I'll develop this a little bit, because, interestingly enough, our tax gap really is not composed of what we typically think of as cheaters. Oftentimes, and this gets back to the dialogue that the Committee had with Mr. Dorgan, what we find is that it's a combination of things. There may be people who intentionally are not complying in the cash economy. We also may have a number of individuals, who are trying to comply but they're either making math errors or, because they don't understand the rules, they're understating their income or they're overstating deductions, credits, or exemptions.

So you can't equate the tax gap solely with tax cheating.

Senator DOMENICI. Mr. Chairman, could I just ask you to clarify those three numbers? My arithmetic doesn't add up, or I've got dollars instead of percentages.

Non-filers is 7.2 billion or 7.2 percent?

Commission GIBBS. $7.2 billion, for the non-filers.

Senator DOMENICI. OK. Those who filed but filed erroneously?

Commissioner GIBBS. About $56.3 billion.

Senator DOMENICI. That's billion?

Commissioner GIBBS. Yes, it certainly is. And I think if you'll add them up, you'll see that that's about 8 percent for the non-filers and about 66 percent for the filers. And that adds up to about 75 percent which, as I mentioned, is basically what the individual tax gap is compared to the total income tax gap.

Senator DOMENICI. So understated income and——

Commissioner GIBBS. Now we're talking about for those who have filed their returns how much of the gap is attributable to folks who understate their income. The point there is that it's about $48.3 billion, or 57 percent of the gap. And as I said, that is the largest factor in the gap.

Does that help from the standpoint of the percentages and dollars?

Senator DOMENICI. I assume then that you arrive at the understated income in its totality through a sample of returns.

Commissioner GIBBS. Yes.

Senator DOMENICI. From a statistical sample of the audits done, you get a result and you extrapolate it across the total horizon, and that tells you if that's where that's coming from.

Commissioner GIBBS. That is correct. That is basically the methodology that we use, Mr. Domenici.

Senator DOMENICI. Thank you, Mr. Chairman.

Senator CONRAD. Mr. Chairman, might I just pick up on that point because, earlier, Senator Domenici had a very good question for Congressman Dorgan about how you'd estimate the effect of additional compliance and assistance.

The way we did it in North Dakota—because we were putting our credibility on the line by saying you give us X amount of money and we will produce Y amount—was to look at what our audit history was. In other words, we didn't go out prospecting, we didn't go out creating new programs. We added resources to our ongoing programs, and many of us who think we could accomplish something of the same order at the Federal level would say that's the appropriate thing for the IRS to do.

And we've got a history, don't we, Commissioner Gibbs, that we could use to estimate what additional resources would do in both the enforcement area and in the area of taxpayer assistance?

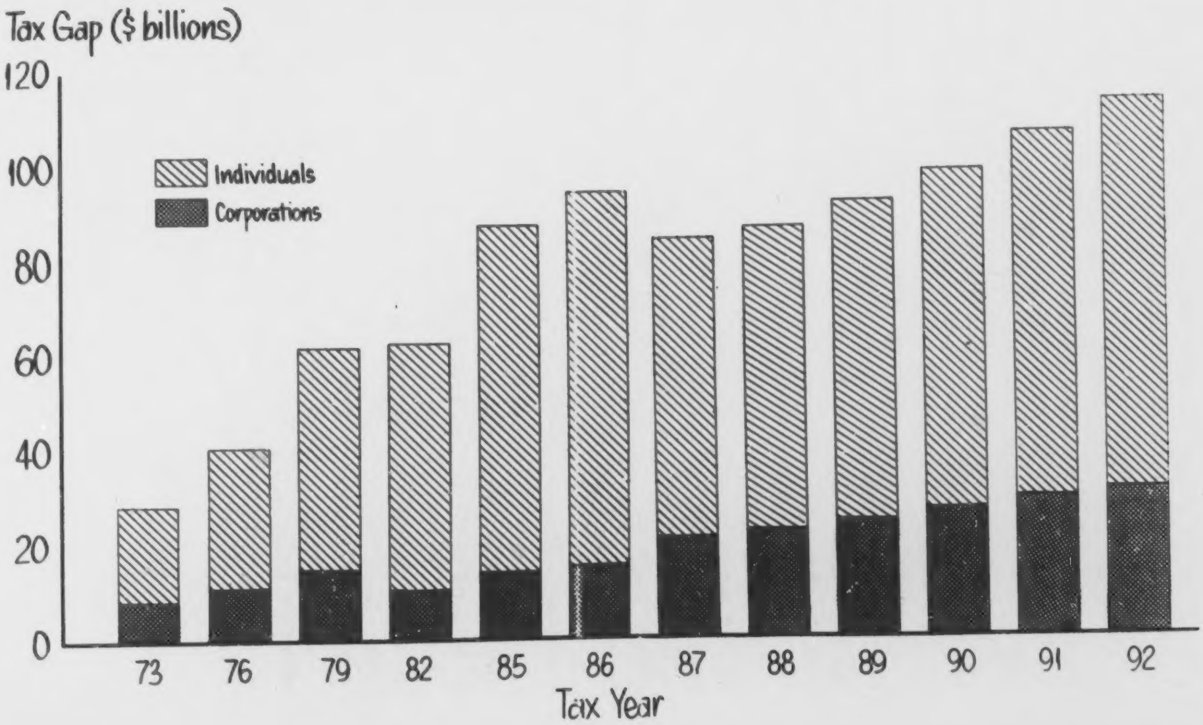
Commissioner GIBBS. Senator Conrad, we do have a past history. We also have models that we use, and those models have been reviewed with the Treasury Department, the Office of Management and Budget, and the Congressional Budget Office. So that we're not talking about something that is simply accepted by the Internal Revenue Service. I'll be glad to develop that a little bit later.

But if it would be helpful, I'd like to go on through and develop this a little bit more for you.

Chairman CHILES. Go ahead.

Commissioner GIBBS. Let's turn to the second chart, if we could.

Estimates of the Gross Tax Gap by Major Component, Selected Tax Years, 1973-1992



The total tax gap in current dollars increased from about $28 billion in 1973 to about $95 billion in 1986. The tax gap fell to $85 billion in 1987 but, as you see, it's projected to rise to $114 billion in 1992.

Overall, the provisions to improve compliance contained in recent legislation have slowed the rate of growth of the tax gap. Taken together, these Acts, the 1981, 1982, 1984, 1986 Acts, have expanded information reporting requirements, and also repealed or limited certain deductions from taxable income or credits from tax, thereby minimizing the possibility for taxpayers to overstate these income offsets or credits.

In addition, tax reform lowered the marginal tax rates, and thereby reduced the gap associated with unreported income. If you think about it, if you have an amount of unreported income and you reduce the rates, you're automatically going to reduce the gap from a comparison standpoint.

In the future, economic expansion and growth will cause the size of the gross tax gap to grow to about $114 billion in 1992. Despite this growth in the size of the tax gap, we believe voluntary compliance rates will improve for individuals.

For 1987, the compliance rate for individuals is about 83½ percent, and is expected to rise to about 84.9 percent in 1992.

I wonder if we could go to the third chart.

Senator DOMENICI. Mr. Chairman, I have one question before he goes on to that. Is this starting in 1987 where we finally get things coming down, and then you have it going up? Is that in constant dollars or is that in current dollars?

Commissioner GIBBS. It's in current—they have not been adjusted. The reason for the rise is the growth in the economy and inflation.

Senator DOMENICI. OK.

Commissioner GIBBS. With respect to the third chart, in 1983 we estimated the gross income tax gap for 1987 to be $115 billion. And today, we estimate the 1987 gap to be about $85 billion, or a decrease of about $30 billion.

Differences Between Old and New Gross Tax Gap Estimates for Tax Year 1987 by Reason for Change (in $ billions)

Old Estimate	115.2
Legislative Changes	-7.6
New Data	-8.8
Improved Methods	-6.8
Omission of Remittance Gap	-7.0
New Estimate	84.9

Now, except for the omission of what we refer to as the remittance gap, and I'll come back to that and explain it, it is important to understand that we did not change the definition of the gross income tax gap from our last report. We are still measuring the same aspects of compliance by individuals and corporations with our income tax laws today, as we did in 1983.

Our new estimates are lower for basically three reasons:

First, the effect of the recent tax law changes; second, the availability of new compliance data; and, third, other factors, including improvements to our methodology and, as I indicated, the omission of the remittance gap in the new estimates. I'll come back to the remittance gap in just a second.

The effects of recent tax law changes have decreased the previous estimate of the individual tax gap for 1987 by $14.4 billion, while increasing the corporation tax gap by $6.8 billion which produces a net decrease when you net individual and corporate together of about $7.6 billion.

On the individual——

Chairman CHILES. Why did the corporate gap increase?

Commissioner GIBBS. I'll cover that, but let me give you a quick answer.

Chairman CHILES. If you're going to cover it later, all right.

Commissioner GIBBS. Senator, thank you. I appreciate that.

A quick answer is there's a different methodology for individuals and corporations, and I'll explain that as we come to it.

On the individual side, tax reform has broadened the tax base by eliminating, restricting or phasing out a number of provisions that individuals use to reduce their tax liabilities. To the extent that a deduction from income is no longer allowed, or a credit is gone, the taxpayer in effect can't overstate it. Also, because tax reform lowered individual rates, as I indicated, it reduces the tax that's associated with unreported incomes.

On the corporation side, the tax gap grew because of increased corporate tax liabilities due to the economic growth and base broadening, and also because we assume a stable rate of voluntary compliance.

We made the assumption that stable corporate compliance rates would continue because it was consistent with the methodology that we have used in the past, and also we have no experience to guide us in predicting the effect of such large changes on the behavior of corporations.

The tax gap estimates are also affected by new data that have become available since 1983, when we did our last study. This accounts for a decrease of about $8.8 billion over our prior estimates.

Previous tax gap estimates were also based largely on compliance data for individuals for 1976 and earlier years. The revised estimates incorporate new compliance data for individuals for the tax years 1979 and 1982. The data we used in developing our 1983 estimates showed a compliance rate for individuals that was falling, and we projected in 1983 that it would continue to fall.

Our new data shows that we were wrong and, instead, the compliance rate for individuals has actually increased. Our new estimates take that into account by assuming not that compliance is going to continue to fall, but that compliance will at least remain steady. We're not predicting that compliance is going to increase, but we have reversed the downward trend and we're just leaving it steady. That, by the way, is the same technique that we're using from the standpoint of corporations. When you assume a corporate voluntary compliance rate that remains steady and recognize that the 1986 act transferred approximately $120 billion of taxes from the individual sector to the corporate sector over a 5-year period, it means you're applying the same voluntary compliance rate to a much larger base. That means you're going to get a larger tax gap with respect to corporations.

And, Mr. Chairman, that's the reason for that growth in the corporate sector.

Our revised estimates that we've also incorporate compliance data on corporate examinations that were closed as recently as 1986. In our prior study that we published in 1983, we only used corporate data through 1980, so we've also improved the data that we're using in the corporate estimate as well.

We also, in addition to having new and better data, have improved our methods for actually estimating the gap, and that has have lowered the gap by some $6.8 billion.

Now, I said I would come back to the remittance gap. Let me discuss it for just a second.

The remittance gap was in our 1983 report. And it basically dealt with a portion of the gap for individuals. These prior estimates were, we felt, somewhat inaccurate, and we are in the process of developing better information with respect to the remittance gap.

The remittance gap reflects instances where an individual will file a return with us but the payment is not attached. So we have a return that's reported but the tax has not been voluntarily paid. Since it hasn't been voluntarily paid, we have to send out our collection notices and so forth. That's why it's part of the tax gap. But we have difficulty in estimating it. We are doing a further study and will have that information for you later this year.

In 1983, it was significant. It was $7 billion for the individual gap. So I want to call it to your attention, tell you that it's not included in our recent study, but we will have the information later this year to supplement our recent study with it.

Let me conclude. I thank you for your patience, but I felt it was important to take you through the tax gap. So let me conclude and we can get to the questions.

In the final analysis, I think the success of our tax administration system and the reduction of the tax gap really depends on three factors.

First, I think taxpayers must perceive the tax law to be fair. If we are willing to give tax reform a chance to be understood and to work, I believe that tax reform will do much to restore the public's confidence in our Nation's tax system.

Second, the Internal Revenue Service must be able to assist taxpayers who want to comply with our tax laws.

And, finally, the Service must also be permitted to take enforcement action against those who fail to pay their fair share.

We have seen improvements in our budgets over the last several years for which I thank this committee, both in terms of improving our tax processing and our taxpayer service programs, and also strengthening our tax enforcement efforts.

The IRS continues to be an effective revenue center for government, generating revenues which support our government, and at a cost of 49 cents for every $100 that we collect. But I believe our tax system can still be improved. I am convinced that a balanced approach between service to the public and ensuring compliance with our Nation's tax laws is essential in the long run to sound tax administration.

What makes our tax system unique is our history of voluntary compliance in this country. How we maintain that system by supporting sound and particularly stable tax laws and an Internal Revenue Service that is capable of providing both service to the public and firm enforcement actions when necessary will, in my opinion, determine the degree to which compliance will continue.

Thank you, Mr. Chairman, and I'll be happy to answer any questions which you and other committee members may have.

Chairman CHILES. Thank you, Mr. Gibbs.

[The prepared statement of Commissioner Gibbs follows:]

Statement of

Lawrence B. Gibbs
Commissioner of Internal Revenue

Before the

Senate Budget Committee

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on

Gross Income Tax Gap Estimates

March 31, 1988

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss with you the latest estimates by the Internal Revenue Service of the size, scope and composition of the income tax gap. I will be happy to answer any questions you might have following my opening statement.

I. INTRODUCTION

Two weeks ago, the Internal Revenue Service issued the latest report on the size and composition of the gross income tax gap. The report contains both good news and bad news. The good news is that the gap for 1987 has declined and the voluntary compliance rate for individuals is improving. The bad news is that the gap is still unacceptably high and is expected to increase in size through 1992.

In 1983, the Internal Revenue Service estimated that the gross income tax gap for 1987 would be $115.2 billion. Since then several major tax bills, including the Tax Reform Act of 1986, have made significant changes to our nation's tax laws which have helped to reduce the gap and to improve compliance by individual taxpayers. We also have developed new data and improved our methods for estimating the gap. Based on our analysis, we now estimate the gross income tax gap for 1987 to be $84.9 billion.

IN LOOKING TOWARDS THE FUTURE, WE PROJECT AN IMPROVED RATE OF VOLUNTARY COMPLIANCE BY INDIVIDUAL TAXPAYERS THROUGH 1992. DESPITE THAT TREND, HOWEVER, ANTICIPATED ECONOMIC EXPANSION AND INFLATION WILL CAUSE THE SIZE OF THE INCOME TAX GAP TO GROW TO NEARLY $114 BILLION IN 1992. ACCORDINGLY, WE AT INTERNAL REVENUE WILL NEED TO CONTINUE TO EFFECTIVELY USE OUR RESOURCES TO PROMOTE VOLUNTARY COMPLIANCE NOT ONLY THROUGH ENFORCEMENT ACTIVITIES, BUT ALSO THROUGH TAXPAYER SERVICE ACTIVITIES WHICH ARE NECESSARY TO ENSURE THE RESPECT AND CONFIDENCE OF TAXPAYERS IN OUR TAX SYSTEM.

MY WRITTEN TESTIMONY TODAY COVERS THREE POINTS. FIRST, IT DEFINES THE TAX GAP AND IDENTIFIES THE TYPES OF TAXES AND ECONOMIC ACTIVITIES THAT ARE INCLUDED IN OUR ESTIMATES AND THOSE THAT ARE NOT. SECOND, IT HIGHLIGHTS THE KEY FEATURES OF OUR ESTIMATES, BOTH FOR INDIVIDUALS AND CORPORATIONS. FINALLY, MY TESTIMONY EXPLAINS WHY OUR TAX GAP ESTIMATES ARE LOWER THAN THOSE PUBLISHED IN 1983.

BEFORE CONTINUING, HOWEVER, THERE ARE SEVERAL IMPORTANT POINTS I WISH TO MAKE. FIRST, OUR ESTIMATES OF THE TAX GAP ARE JUST THAT -- ESTIMATES. ALTHOUGH THEY ARE DEVELOPED WITH A HIGH DEGREE OF PROFESSIONALISM AND WITH THE BEST DATA AVAILABLE, BY THEIR VERY NATURE THEY ARE SUBJECT TO GREATER VARIATION THAN MOST ESTIMATES. PARTICULARLY IN ESTIMATING THE INCOME TAX GAP FOR THE CORPORATE SECTOR, WE HAVE LIMITED DATA

ON WHICH TO BASE OUR ESTIMATES. CONSEQUENTLY, THE TAX GAP ESTIMATES FOR CORPORATIONS ARE SUBJECT TO MORE UNCERTAINTY THAN THOSE FOR INDIVIDUALS. I WILL EXPLAIN THE METHODOLOGY USED IN ESTIMATING THE CORPORATE TAX GAP IN GREATER DETAIL LATER ON IN MY TESTIMONY.

SECOND, OUR ESTIMATES OF THE INCOME TAX GAP ARE MEASURES OF TOTAL NONCOMPLIANCE. THEY ARE NOT INTENDED TO BE MEASURES OF THE POTENTIAL FOR ADDITIONAL ENFORCEMENT YIELDS BECAUSE THEY ARE MADE UP OF THREE VERY SPECIFIC AND DIFFERENT COMPONENTS:

(1) AMOUNTS WHICH ARE EVENTUALLY COLLECTED THROUGH CURRENT ENFORCEMENT ACTIVITIES,

(2) AMOUNTS WHICH ARE NOT COLLECTED THROUGH CURRENT ENFORCEMENT ACTIVITIES AND WOULD BE COST EFFECTIVE TO COLLECT, AND

(3) AMOUNTS WHICH ARE NOT COLLECTED THROUGH CURRENT ENFORCEMENT ACTIVITIES AND WOULD NOT BE COST EFFECTIVE TO COLLECT.

SPECIFIC ESTIMATES OF THE RELATIVE SIZE OF EACH OF THESE THREE COMPONENTS WILL BE AVAILABLE LATER THIS YEAR.

II. INCOME TAX GAP ESTIMATES

A. DEFINITION OF GROSS TAX GAP

GROSS TAX GAP IS THE AMOUNT OF INCOME TAX OWED BUT NOT VOLUNTARILY PAID.

SINCE THE TAX GAP IS AN IMPORTANT MEASURE OF AMOUNT AND TYPES OF NONCOMPLIANCE ENCOUNTERED IN COLLECTING TAXES, THIS BRIEF DEFINITION NEEDS FURTHER ELABORATION. FIRST, THE TAX GAP ESTIMATES ARE CONCERNED ONLY WITH INCOME TAXES, BOTH INDIVIDUAL AND CORPORATE. WHILE THERE ARE GAPS ASSOCIATED WITH OTHER TYPES OF TAXES, SUCH AS EMPLOYMENT AND EXCISE TAXES, THEY ARE NOT INCLUDED IN OUR ESTIMATES BECAUSE WE DO NOT YET HAVE THE DATA AND METHODS AVAILABLE TO MEASURE THEM AND ANALYZE TRENDS WITH RESPECT TO THEM.

SECOND, THE WORD "VOLUNTARILY" MEANS WITHOUT IRS ENFORCEMENT ACTION INVOLVING OUR COLLECTION, EXAMINATION, AND OTHER RELATED FUNCTIONS. IRS, THROUGH THESE ENFORCEMENT PROGRAMS, ASSESSES AND COLLECTS PART OF WHAT TAXPAYERS OWE BUT DO NOT VOLUNTARILY PAY. AS I MENTIONED PREVIOUSLY, ESTIMATES

OF THE "NET TAX GAP" WHICH REMAINS AFTER OUR ENFORCEMENT ACTIONS ARE CURRENTLY BEING DEVELOPED AND WILL BE PUBLISHED LATER THIS YEAR.

FINALLY, OUR TAX GAP ESTIMATES ACCOUNT FOR NONCOMPLIANCE IN THE "REGULAR ECONOMY" AND ALSO THE LEGAL SECTOR OF THE "UNDERGROUND ECONOMY", SUCH AS UNREPORTED INCOME BY MOONLIGHTING MECHANICS OR SIDEWALK VENDORS. THEY DO NOT INCLUDE INCOME FROM THE ILLEGAL SEGMENT OF THE UNDERGROUND ECONOMY WHICH IS EXTREMELY DIFFICULT TO MEASURE AND TAX.

IN ADDITION TO UNDERSTANDING WHAT THE TAX GAP IS, IT IS ALSO IMPORTANT TO UNDERSTAND WHY IT EXISTS. THE TAX GAP EXISTS BECAUSE SOME INDIVIDUALS AND BUSINESSES:

- UNDERSTATE INCOME,
- OVERSTATE DEDUCTIONS, EXEMPTIONS AND CREDITS,
- MAKE MATH ERRORS ON THE TAX RETURNS THEY FILE, OR
- DO NOT FILE THE TAX RETURNS THEY ARE REQUIRED TO FILE.

THE TAX GAP EXISTS BECAUSE CERTAIN TAXPAYERS INTENTIONALLY AVOID PAYING THEIR FAIR SHARE OF TAXES. HOWEVER, IT ALSO EXISTS BECAUSE HONEST TAXPAYERS WHO ARE TRYING TO COMPLY WITH OUR NATION'S TAX LAWS MAKE MISTAKES WHEN THEY FILE THEIR

RETURNS. THEY MISTAKENLY FAIL TO INCLUDE ALL OF THEIR INCOME, ERRONEOUSLY CLAIM DEDUCTIONS OR CREDITS THEY ARE NOT ENTITLED TO, OR MAKE MATH ERRORS WHEN THEY FILL OUT THEIR TAX RETURNS.

B. 1987 INDIVIDUAL INCOME TAX GAP

THE INDIVIDUAL GROSS INCOME TAX GAP OF $63.5 BILLION REPRESENTS 75 PERCENT OF THE TOTAL INCOME TAX GAP. IT CONSISTS OF A $7.2 BILLION TAX GAP FOR INDIVIDUALS WHO FAIL TO FILE REQUIRED INCOME TAX RETURNS, AND A $56.3 BILLION TAX GAP FOR INDIVIDUALS WHO FILE RETURNS BUT WHO UNDERSTATE INCOME, OVERSTATE SUBTRACTIONS (ITEMIZED DEDUCTIONS, EXEMPTIONS OR CREDITS) OR MAKE MATH ERRORS.

UNDERREPORTED INCOME ACCOUNTS FOR $48.3 BILLION OF THE INDIVIDUAL FILER TAX GAP WITH SOLE PROPRIETOR INCOMES ACCOUNTING FOR ABOUT HALF OF THIS AMOUNT. ABOUT $16.6 BILLION OF THE TAX GAP IS DUE TO UNDERSTATED NONFARM BUSINESS INCOME OF SELF-EMPLOYED INDIVIDUALS, WHILE AN ESTIMATED $7.7 BILLION IS UNREPORTED BY "INFORMAL SUPPLIERS" WHO TEND TO OPERATE "OFF THE BOOKS". INFORMAL SUPPLIERS INCLUDE ROADSIDE OR SIDEWALK VENDORS, MOONLIGHTING CRAFTSMEN OR MECHANICS, UNLICENSED PROVIDERS OF CHILD OR ELDERLY CARE SERVICES, AND SIMILAR OPERATORS WITH AN INFORMAL BUSINESS STYLE.

WHEN INCOME IS SUBJECT TO WITHHOLDING, COMPLIANCE IN REPORTING SUCH INCOME IS HIGHEST. FOR EXAMPLE, A VERY LARGE PORTION OF WAGE AND SALARY INCOME IS COVERED BY WITHHOLDING, AND WE ESTIMATE THAT 99.5 PERCENT OF SUCH INCOME IS VOLUNTARY REPORTED. THE VOLUNTARY REPORTING PERCENTAGE FOR PENSION AND ANNUITY INCOME FOR WHICH WITHHOLDING IS OPTIONAL IS ESTIMATED TO BE ALMOST AS HIGH -- 98.4 PERCENT. INCOME THAT IS COMPLETELY COVERED BY INFORMATION REPORTS REFLECTS AN ESTIMATED VOLUNTARY REPORTING PERCENTAGE THAT IS SLIGHTLY LOWER -- FOR EXAMPLE, 94.6 PERCENT OF INTEREST AND DIVIDEND INCOME IS VOLUNTARILY REPORTED. IF INFORMATION REPORTING IS LESS COMPLETE, THE PERCENTAGE DECLINES -- ONLY 88.3 PERCENT OF CAPITAL GAINS IS INITIALLY REPORTED. WHEN IRS RECEIVES NO INFORMATION ON THE INCOMES EARNED AND TAXPAYERS KEEP POOR BOOKS AND RECORDS, COMPLIANCE TENDS TO BE POOR. THUS, WE ESTIMATE THAT ONLY 13.1 PERCENT OF INFORMAL SUPPLIER INCOME IS VOLUNTARILY REPORTED.

C. 1987 CORPORATION INCOME TAX GAP

THE CORPORATION GROSS INCOME TAX GAP OF APPROXIMATELY $21 BILLION REPRESENTS ABOUT 25 PERCENT OF THE TOTAL INCOME TAX GAP FOR 1987. LARGE CORPORATIONS WITH $10 MILLION OR MORE IN ASSETS DOMINATE THE TOTAL CORPORATE GAP BY ACCOUNTING FOR $15.8 BILLION. SMALLER CORPORATIONS ACCOUNT FOR THE REMAINING $5.2 BILLION, SPLIT ALMOST EQUALLY BETWEEN UNDERREPORTED INCOME AND OVERSTATED DEDUCTIONS AND CREDITS.

AS INDICATED PREVIOUSLY, OUR ESTIMATES OF THE CORPORATE TAX GAP ARE LESS PRECISE THAN THOSE FOR THE INDIVIDUAL TAX GAP. IN COMPUTING OUR CORPORATE TAX GAP FIGURES, WE HAVE ASSUMED THAT RECENT TAX LAW CHANGES WILL HAVE NO EFFECT EITHER POSITIVELY OR NEGATIVELY ON THE CORPORATE VOLUNTARY COMPLIANCE RATE FOR REPORTING OVERALL TAX LIABILITIES. ACCORDINGLY, WE HAVE APPLIED AN AVERAGE 82.5% VOLUNTARY COMPLIANCE RATE AGAINST AN INCREASING CORPORATE TAX BASE TO ARRIVE AT THE PROJECTED INCREASES IN THE CORPORATE TAX GAP. THIS METHODOLOGY IS CONSISTENT WITH THE MANNER IN WHICH WE HAVE COMPUTED THE CORPORATE TAX GAP IN THE PAST.

AN ALTERNATIVE METHOD OF COMPUTING THE CORPORATE TAX GAP WOULD BE TO ASSUME CONSTANT VOLUNTARY REPORTING PERCENTAGES FOR EACH OF THE ELEMENTS USED TO CALCULATE CORPORATE NET INCOME (RECEIPTS, COST OF GOODS SOLD, AND EXPENSES). USING THIS METHOD, THE CORPORATE TAX GAP ESTIMATE WOULD PROBABLY DECREASE DUE TO THE RECENT REPEAL OF THE INVESTMENT TAX CREDIT AND CORPORATE RATE REDUCTIONS. WE HAVE NOT USED THIS METHOD BECAUSE WE DO NOT HAVE INFORMATION THAT REFLECTS THE VOLUNTARY REPORTING PERCENTAGES OF THE VARIOUS ELEMENTS OF CORPORATE NET INCOME. IN THE FUTURE, WE WILL CONTINUE TO SEEK BETTER METHODS OF ESTIMATING THE CORPORATE TAX GAP.

D. TRENDS

The total tax gap in current dollars shows an increase from $28 billion for 1973 to $95 billion in 1986. The tax gap falls to $85 billion in 1987, but is projected to rise to $114 billion in 1992.

Overall, the provisions to improve compliance contained in the Tax Equity and Fiscal Responsibility Act of 1982, the Interest and Dividend Tax Compliance Act of 1983, the Deficit Reduction Act of 1984 and the Tax Reform Act of 1986 have slowed the rate of growth of the tax gap. These acts made several important improvements in ensuring taxpayer compliance. They expanded the information reporting requirements, and they also repealed or limited many deductions from taxable income, thereby minimizing the possibility for taxpayers to overstate these income offsets. In addition, the Tax Reform Act of 1986 lowered marginal tax rates, thus reducing the tax gap associated with unreported income.

The estimated growth of the tax gap over the years is largely due to the growth of income tax liabilities through real expansion of the economy and inflation. Therefore, the tax gap can increase even though compliance rates are relatively stable or are improving. For example, the individual tax gap more than doubled from $19.7 billion in 1973

TO $46.8 BILLION IN 1979 EVEN THOUGH THE VOLUNTARY COMPLIANCE RATE DECREASED BY ONLY ABOUT THREE PERCENTAGE POINTS, FROM 84.6 PERCENT IN 1973 TO 81.8 PERCENT IN 1979. THE TAX GAP THEN CONTINUED TO GROW TO $51.9 BILLION IN 1982 EVEN AS THE VOLUNTARY COMPLIANCE RATE IMPROVED TO 83.7 PERCENT. IN 1987, THE INDIVIDUAL TAX GAP AND VOLUNTARY COMPLIANCE RATE STAND AT $63.5 BILLION AND 83.5 PERCENT RESPECTIVELY. BY 1992 BOTH ARE EXPECTED TO INCREASE TO $83 BILLION AND 84.9 PERCENT.

III. COMPARISONS WITH PRIOR IRS ESTIMATES

THE REVISED GROSS INCOME TAX GAP ESTIMATES REFLECT A DECREASE OF $30.3 BILLION OVER OUR 1983 ESTIMATES FOR 1987. THE INDIVIDUAL ESTIMATES HAVE DECREASED BY $40.5 BILLION WHILE THE CORPORATION ESTIMATES HAVE INCREASED BY $10.2 BILLION.

EXCEPT FOR THE OMISSION OF THE REMITTANCE GAP, IT IS IMPORTANT TO UNDERSTAND THAT WE DID NOT CHANGE OUR DEFINITION OF THE GROSS INCOME TAX GAP FROM OUR LAST REPORT. WE ARE STILL MEASURING THE SAME ASPECTS OF COMPLIANCE BY INDIVIDUALS AND CORPORATIONS WITH THE INCOME TAX LAWS AS WE DID IN 1983. HOWEVER, OUR NEW ESTIMATES ARE LOWER BECAUSE OF THE EFFECT OF RECENT TAX LAW CHANGES ON THE TAX BASE, THE AVAILABILITY OF NEW COMPLIANCE DATA, AND OTHER FACTORS INCLUDING IMPROVEMENTS IN METHODOLOGY AND THE OMISSION OF THE REMITTANCE GAP IN THE NEW ESTIMATES.

A. RECENT TAX LAW CHANGES

RECENT TAX LAW CHANGES HAVE BROADENED THE TAX BASE BY ELIMINATING, RESTRICTING AND PHASING OUT A NUMBER OF PROVISIONS THAT INDIVIDUALS PREVIOUSLY USED TO REDUCE THEIR TAX LIABILITIES. TO THE EXTENT THAT A DEDUCTION FROM INCOME IS NO LONGER ALLOWED, AN INDIVIDUAL CANNOT OVERSTATE IT ON THE TAX RETURN. THIS REDUCES NONCOMPLIANCE. IN ADDITION, BECAUSE TAX REFORM ALSO REDUCED THE RATES AT WHICH INDIVIDUAL INCOMES ARE TAXED, IT REDUCES THE TAX GAP ASSOCIATED WITH UNREPORTED INCOME. AS A CONSEQUENCE, RECENT TAX LAW CHANGES DECREASED THE PREVIOUS INDIVIDUAL INCOME TAX GAP ESTIMATE FOR 1987 BY $14.4 BILLION. THE CORPORATE TAX GAP ESTIMATE INCREASED BY $6.8 BILLION BECAUSE OF INCREASED CORPORATE TAX LIABILITIES CAUSED BY ECONOMIC GROWTH AND BASE BROADENING, AND BECAUSE WE ASSUMED STABLE RATES OF VOLUNTARY REPORTING OF OVERALL CORPORATE TAX LIABILITIES. ABSENT VOLUNTARY REPORTING INFORMATION FOR THE DETAILED INCOME AND EXPENSE ITEMS MAKING UP CORPORATE NET INCOME, WE WERE NOT ABLE TO PREDICT IN A MORE SOPHISTICATED MANNER THE SPECIFIC EFFECTS OF TAX LAW CHANGES ON CORPORATE COMPLIANCE.

B. NEW DATA

THE TAX GAP ESTIMATES WERE ALSO AFFECTED BY NEW DATA THAT BECAME AVAILABLE SINCE THE 1983 IRS REPORT ON THE TAX GAP WAS PUBLISHED. THE PREVIOUS IRS TAX GAP ESTIMATES WERE BASED

LARGELY ON COMPLIANCE DATA ON INDIVIDUALS FOR 1976 AND EARLIER YEARS. THE REVISED ESTIMATES INCORPORATE COMPLIANCE DATA ON INDIVIDUALS FOR TAX YEARS 1979 AND 1982. THE DATA WE HAD IN 1983 SHOWED THAT THE COMPLIANCE RATE WAS FALLING, AND WE PROJECTED THAT IT WOULD CONTINUE TO FALL. THE COMPLIANCE DATA FOR 1982 -- WHICH BECAME AVAILABLE IN 1985 -- SHOWED THAT WE WERE WRONG. COMPLIANCE HAD INCREASED. OUR NEW ESTIMATES REFLECT THIS IMPROVEMENT. FOR LARGE CORPORATIONS OUR EARLIER ESTIMATES WERE BASED ON EXAMINATIONS CLOSED IN 1980 AND EARLIER YEARS; OUR REVISED COMPLIANCE ESTIMATES ARE BASED ON EXAMINATIONS CLOSED AS RECENTLY AS 1986. IN ADDITION, THE REVISED ESTIMATES INCLUDE DATA FROM A 1985 HOUSEHOLD SURVEY THAT PROVIDED INFORMATION ON INFORMAL SUPPLIERS WORKING "OFF THE BOOKS" AND FROM OTHER SPECIAL STUDIES.

THE REVISIONS RESULTING FROM THESE NEW DATA SOURCES LOWER THE 1987 ESTIMATE OF THE INDIVIDUAL GAP BY $8.4 BILLION, WHILE LOWERING THE CORPORATE GAP BY $0.4 BILLION.

C. OTHER FACTORS

IMPROVEMENTS IN OUR ESTIMATION METHODS LOWER THE INDIVIDUAL GAP ESTIMATE BY $10.7 BILLION IN 1987 WHILE CHANGES IN OUR CORPORATE ESTIMATION METHODS RAISE THE CORPORATE GAP BY $3.9 BILLION FOR 1987.

The individual income tax gap estimates in our 1983 report also contained estimates for the remittance gap which are taxes reported to the Internal Revenue Service but not paid. Because prior estimates of the remittance gap were very inaccurate, our revised estimates exclude this measure until such time that we can develop an accurate measure. Omission of the remittance gap accounts for roughly $7.0 billion of the difference between previous and current estimates of the overall tax gap.

IV. CONCLUSION

Mr. Chairman, in the final analysis the success of our tax administration system and the reduction of the income tax gap rely on three factors. First, taxpayers must believe that the tax laws are fair. If we are willing to give the 1986 Tax Reform Act a chance to be understood and to work, I believe that it will do much to restore public confidence in the fairness of our nation's tax system. Second, the Internal Revenue Service must be able to assist those taxpayers who are trying to comply with their tax obligations. Finally, the IRS must be permitted to take enforcement action against those who do not comply and who thereby fail to pay their fair share of tax.

WE HAVE SEEN IMPROVEMENTS IN OUR BUDGET OVER THE LAST SEVERAL YEARS, BOTH IN TERMS OF IMPROVING OUR TAX PROCESSING AND TAXPAYER SERVICE PROGRAMS AND STRENGTHENING OUR TAX ENFORCEMENT EFFORTS. AN IMPORTANT OBJECTIVE IN OUR FY 1989 BUDGET IS TO CONTINUE THE MODERNIZATION OF OUR COMPUTER SYSTEMS TO IMPROVE THE QUALITY OF SERVICE WE ARE ABLE TO PROVIDE AND TO ENHANCE OUR TAX ENFORCEMENT CAPABILITY.

THE INTERNAL REVENUE SERVICE CONTINUES TO BE AN EFFECTIVE REVENUE CENTER FOR GOVERNMENT, GENERATING THE REVENUES UPON WHICH OUR GOVERNMENT DEPENDS, AT A COST OF ABOUT 49 CENTS FOR EVERY $100 COLLECTED. OUR TAX SYSTEM CAN STILL BE IMPROVED. I AM CONVINCED THAT A BALANCED APPROACH BETWEEN SERVICE TO THE PUBLIC AND ENSURING COMPLIANCE WITH OUR NATION'S TAX LAWS IS ESSENTIAL IN THE LONG RUN TO SOUND TAX ADMINISTRATION.

WHAT MAKES OUR TAX SYSTEM UNIQUE IS OUR TRADITION OF VOLUNTARY COMPLIANCE. HOW WE MAINTAIN THAT TAX SYSTEM -- BY SUPPORTING SOUND AND PARTICULARLY STABLE TAX LAWS AND AN INTERNAL REVENUE SERVICE THAT IS CAPABLE OF PROVIDING BOTH SERVICE TO THE PUBLIC AND FIRM ENFORCEMENT ACTIONS WHEN NECESSARY -- WILL DETERMINE THE DEGREE TO WHICH COMPLIANCE WILL CONTINUE.

Chairman CHILES. I think we will hear from everybody after we hear from all the members of the panel. Mr. Kurtz, we thank you, again, for your appearance, too.

STATEMENT OF JEROME KURTZ, FORMER COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. KURTZ. Thank you, Mr. Chairman, and members of the committee. I have a statement that I would appreciate having put in the record, and I will just summarize it.

Chairman CHILES. Your statement will be placed in the record.[1]

Mr. KURTZ. Thank you. First, let me agree wholeheartedly with the beginning of Larry Gibbs 'statement, when he said that these estimates are just that, they are estimates. Moreover we should keep in mind that they are estimates of what people are trying to hide, so they are subject to a fairly wide margin of error.

I think it is a mistake to try to draw much out of minor variations in statistics that may just as well reflect differences in statistical methodology as any improvements or declines in compliance.

Just because the estimates are stated in decimal places, it would be a mistake to focus on those decimal places. What does this study tell us, and what does it not tell us?

In my view, it does not tell us anything useful about trends in compliance. The differences in voluntary compliance rates over the years are minuscule, and as likely to be attributable to better or worse auditing methods in a particular year, or to minor changes in the law, than they are to any increase or decrease in volunteerism.

That is not at all inconsistent with anything that Larry said.

As to the future, the estimates only predict mathematical changes. For example, if there is a certain amount of noncompliance with a deduction for sales taxes, and the deduction for sales taxes is eliminated, voluntary compliance will improve to the extent that people cheated on sales taxes.

But that, again, does not measure any attitudinal change, or change in people's willingness, or lack of willingness to comply with the law.

I might also say it particularly does not say anything as to current trends, because the last information available, on which these estimates are based, is 1982.

Let me say, I do not mean to be critical of the study. I think it is a good study. Much of its methodology is a substantial improvement over prior studies. But this estimating is a very inexact science.

Having said that, let me address what we should get out of the tax gap report? In my view, the first is that the tax gap is large, and it is larger than it needs to be.

It tells us some things that are obvious about where the tax gap is, and some things that are not obvious. For example, it tells us that compliance is very, very high on wages subject to withholding. That is not a surprise to anyone.

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[1] See p. 339.

It tells us that compliance is also high where there is information reporting, but not as high as where there is withholding. So that in the area of interest, dividends, so-called independent contractors, there is room for improvement of compliance, and a pick up of substantial amounts of money, according to this study, by imposing withholding, rather than information reporting.

It also tells us that the gap is very large where there is no information reporting and no withholding. That is the informal economy, the neighborhood storekeepers, the taxi drivers, waiters, waitresses. Very low compliance.

So it tells us that if we can get information reporting we will improve compliance. In areas where this is not possible, the primary way to address the gap is by increased examinations.

These comments focus on legislative ways to improve compliance. But there is another factor that both Larry and Byron Dorgan mentioned earlier, and that is the aspect of service.

And I would describe service rather more broadly than helping taxpayers. I think it is an important aspect of people's willingness to comply with the tax laws if people view the tax collector, the Internal Revenue Service in this case, as being fair and efficient, able to answer questions, able to answer mail, able to straighten out accounts, able to do an examination, handle the appeal quickly, dispose of the case, collect the debts—do all of those things efficiently, compliance will improve. I think that goal does not reflect people's experience with the IRS in recent years, not due to any fault of the IRS, but rather to the historic underfunding of IRS which has gotten worse in recent years.

The common experience today is that if you have to write a letter to the IRS to straighten out an account you are going to learn the meaning of frustration.

We have all seen that. Yet, the IRS does not deserve the harsh criticism it gets. My view is that the American people are getting a lot more than they deserve out of the IRS, considering the way the IRS has been underfunded and the job that it has been given to do.

But I do believe very firmly—although I do not believe it is measurable with any precision—but I do believe very firmly that voluntary compliance—that is, the amount of taxes that people voluntarily pay—can be improved very substantially by creating an IRS with a different image, and that means spending more money, not just for enforcement, although enforcement is not unimportant.

It is important, particularly to the person who is not audited, to feel that others are paying their fair shares, and that people are not cheating the government out of large amounts of money while his pay check is withheld on for 100 percent. It is also important for people to feel that if they pick up the telephone and call the IRS, somebody will be there who will answer their question and who will give the right answer.

The ability of the IRS to do that is not a question of will and not one of ability, but one of resources, and to go back to a question that was raised earlier by Senator Domenici, about pay levels.

That last point is critically important. The IRS needs not just more people, but it needs better pay to get people with the technical ability to handle this Internal Revenue Code, and to handle the very sophisticated computer installations, et cetera.

In a range of technical professions—accountants, lawyers, computer specialists, et cetera—the IRS pay scales are not competitive with private industry. Now I do not think pay has to be exactly competitive. There are rewards for working for the government. There are, you know, feelings of pride that attract people to work with the government, but pay cannot be so noncompetitive that career people feel seriously abused and grossly underpaid. The evidence is mounting that the IRS simply does not have the ability to hire enough people with adequate skills to do the job, even if it were given the gross resources.

I think these issues have to be examined. I might add just one note, and that is the question of how anyone would estimate what compliance improvements one could get from improving taxpayer service. That is virtually an impossible estimating job. But the Government estimates a lot of other things that are impossible to estimate.

But I think the point, more important than showing a positive payoff for improved service, is that it should not be viewed as a net expenditure. I think that is the issue. If we spend another billion dollars on the IRS over the years I do not think anyone can seriously debate, whether that billion dollars will be returned. My own sense is that it will be returned many times. I cannot prove it, but having worked in this field for a lot of years I believe it, and I think everyone else who has done so, also believes it. I do not think anyone believes that it is a net loss.

Thank you.

Chairman CHILES. Thank you, Mr. Kurtz.

[The prepared statement of Mr. Kurtz follows:]

TESTIMONY OF JEROME KURTZ
COMMITTEE ON THE BUDGET
UNITED STATES SENATE
HEARING ON THE "TAX GAP"
MARCH 31, 1988

Mr. Chairman and Members of the Committee:

I appreciate the Committee's invitation to participate in this important hearing addressing the measurement and significance of the tax gap and possible enforcement initiatives.

The tax gap estimates published by the Internal Revenue Service this month are the result of continuing study and analysis aimed at refining the estimates of the amount of taxes due but not reported on returns. These studies are important for what they tell us about where the problems with our tax system lie and, consequently, what they might suggest about solutions. At the same time, we should keep clearly in mind that these estimates are just that -- estimates; and more particularly, they are estimates of what people are trying to hide and therefore subject to wide margins of error. Without in any way diminishing the importance of the IRS's work in this area, I'd like to make a few observations about the limitations of these estimates.

1. Thus far, tax gap estimates have been unable to tell us very much, if anything, about trends in compliance. While these latest estimates show a smaller tax gap than prior estimates, the change is not due to an improvement in compliance but rather to more refined measurement techniques. In other words, the prior estimates were simply too high.

2. Even using the new techniques, the estimates do not tell us anything about recent compliance trends because the individual estimates are based on tax returns filed in 1979 and 1982; the most recent data available, but is already six years old. I say this not to be critical in any way of the Service's report but rather to respond to press accounts of significant improvements in compliance. Such may or may not be the case.

3. The dollar amount of the gap is growing but, again, there is little indication of a decline in compliance. The increased gap arises primarily from an increase in the total amount of income tax due because of population increases and inflation. The slight declines in compliance percentages as measured by TCMP over the years might just as easily be attributed to improved auditing as to declining compliance.

4. While voluntary compliance rates are projected to improve slightly over time, the change is attributable to the elimination of some deductions and the lowering of individual marginal rates rather than to any increased volunteerism.

5. On other hand. the corporate tax gap is projected to increase because the 1986 Act shifted a significant amount of tax from individuals to corporations. It should be noted that the largest portion of the corporate tax gap, that attributable to large corporations, is not an estimate of the tax gap at all but rather only the result of actual audits. How much is unreported and undiscovered on audit is unknown.

Notwithstanding these limitations there is much that is valuable to be learned from these estimates.

1. The tax gap is large. Even if the estimates are not precise, losses in the order of magnitude disclosed are a problem worthy of serious attention. Our tax system should work better.

2. The location of the underreporting in some cases confirms our intuition. It is not at all surprising that compliance is highest for salary and wages where there is information reporting and withholding. Compliance is also high, but not quite so high, for interest and dividends where there is information reporting but no withholding. In those areas where there is no "paper trail" and no reporting -- informal suppliers and farm and nonfarm proprietors -- compliance is poor. The policy conclusion that obviously flows from this is that compliance will be better if withholding is provided wherever possible, and that where withholding is not possible, information reporting be provided as broadly as it can be.

3. In other instances, the amount of noncompliance comes as a surprise -- at least to me. For example, the very low compliance shown for rental income deserves further investigation. What kind of rents? Paid by and to whom? Is the problem underreporting of receipts or exaggeration of expenses? Can anything be done to improve compliance in this area -- legislatively or administratively?

4. The areas of greatest noncompliance are informal suppliers and farm and nonfarm proprietors. Enforcement in those cases means increased audit activity.

In my view, the most important conclusion to be drawn from the tax gap estimates is that there is a problem of serious proportions in administering the tax system. The report doesn't tell us much about how to solve it. Better enforcement may be part of the solution -- but only a part. I believe that voluntary compliance depends on much more than enforcement. In a broad sense, it depends on taxpayers' feelings that they are treated fairly both by the tax law and by its administrators; that others are paying their fair share; and that the IRS is able to do its job effectively and efficiently.

I believe the 1986 Tax Act significantly improved the fairness of the tax law. The law could use further simplification and I hope more attention will be paid this problem in the future.

With an improved tax law, I urge that greater attention now be paid to improving tax administration.

If the IRS does more and better auditing of tax returns, taxpayers will be inclined to report more honestly on their own. In 1980, 2.5% of income tax returns were audited by the IRS. Last year the number was less than 1.2%. The IRS is generally less efficient than in the past due to years of underfunding and the rapid pace of new legislation. Taxpayer assistance is less available and less accurate. Backlogs in all areas are at or near record levels. Anyone who has had to correspond with the IRS knows the meaning of frustration. This is the direct result of too few resources provided to the IRS to do the job required.

The IRS should have additional funding to allow it to expand its personnel significantly. New resources should be devoted not only to increasing the number and improving the quality of audits and collection activities but to helping taxpayers cope with the system by improving both the timeliness and accuracy of telephone assistance, providing more convenient IRS offices and greater assistance to taxpayers in return preparation, and to answering mail and resolving taxpayers' problems promptly, among other specific recommendations.

I firmly believe that if the IRS gives prompt, courteous and accurate advice, if it presents itself to the public as efficient, helpful, knowledgeable and able to enforce the law evenhandedly and expeditiously, if taxpayers believe that others are paying their share and that all are fairly treated, they will respond by filing more accurate returns. If voluntary compliance improved by one percentage point, the revenue gain would be about $7 billion this year.

This program will not solve the deficit problem but it will help and it is fair.

Chairman CHILES. Mr. Alexander.

STATEMENT OF DONALD C. ALEXANDER, FORMER COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. ALEXANDER. Thank you, Mr. Chairman. I have a statement which I will not read.

Chairman CHILES. We will place that in the record.[1]

Mr. ALEXANDER. I simply want to echo some things that have been said already because I find myself in almost complete agreement with what——

Chairman CHILES. Pull your mike up just a little bit more, if you will.

Mr. ALEXANDER. All right, sir. Can you hear me now, sir? A little better?

Chairman CHILES. Yes, sir.

Mr. ALEXANDER. I was just going to echo, really, what Jerry Kurtz said, and say that I am in almost complete agreement with what Commissioner Gibbs said.

But one thing I want to mention here. Something may be made of the comparison between this $85 billion number and an earlier number that was bigger.

I think it is difficult to measure trends, I agree with Jerry Kurtz, and furthermore, we should not lose sight of the fact that the $85 billion number may be considered by the media to be something that it is not.

That is not the complete tax gap. As Commissioner Gibbs has said, it does not include the unpaid, but due excise taxes, or employment taxes that should have been paid.

It does not include estate and gift taxes that should have been paid but were not. It does not include a massive number, and that is the tax that the illegal sector of our economy ought to be paying but are not.

They do not comply with their tax responsibilities very well.

And I was trying to get a number on the illegal sector to find out how big the FBI or DEA said it was. I thought there would be a number out there, Mr. Chairman, and I thought they would want to give you a great big number and say this is it, so you would give them a great big budget to cope with it.

But instead, it seems to be a well-concealed number, and all I could find was that somebody would estimate the drug traffic in this country to produce about $100 billion in revenues yearly.

Now if you use a 30 percent profit—you would find a pretty healthy profit—and it is fair to say, I think, that even under the skilled leadership of Commissioner Gibbs, that not much of that is being taxed.

If Commissioner Gibbs could find it, you can be sure that he would tax it. So, we have a number that is too small. We have a universe that is far bigger than the universe that is the subject of this $85 billion measurement, and we should not lose sight of it.

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[1] See p. 345.

Now some of that $85 billion is already recovered. I think the Internal Revenue estimate shows about $20 billion, or something, that has been picked up out of that 85. Is that correct, Larry?

Commissioner **Gibbs**. Yes; Don, that is right. We estimate that it is somewhere in the $20 billion range, as I indicated, we will have a further estimate later this year. It is somewhere in that range.

Mr. **Alexander**. But yet, there is a $7 billion remittance gap that was in the earlier number, that is not in the present number because of the difficulty of measuring that number.

But nevertheless, that offsets the 20—whatever it is—when you are trying to figure what the national revenues would be if we could have a meaningful reduction of this gap, and I am convinced that we can have a meaningful reduction. I am convinced that our tax laws work very well where there is withholding, almost as well where there is information reporting, and not well at all in other areas. The tax laws could work better if there were a combination of efforts, stronger and more effective, and also responsive enforcement.

And also more responsive taxpayer service in the broad sense, that Jerry Kurtz used, to the public. To the public in North Dakota, and to the public in all the other States, and in the District of Columbia, if we were able to give the public what the public deserves from the Internal Revenue Service.

If a taxpayer is required to file an annual return and a correct return, the taxpayer should be given guidance and assistance in the preparation of that return, and in the processing of that return.

The Internal Revenue Service estimated in 1986 that taxpayer service prevented what would otherwise be a revenue loss of about $1.3 billion. I think that is small.

I agree with Jerry Kurtz. I think taxpayer service pays for itself far more than the $1.3 billion figure would indicate, and I think we are using a different standard of measurement here when we are talking about administrative changes than when we are talking about structural changes in the code.

Somehow, revenue estimators can decide how taxpayers are going to behave if the capital gains rate were cut to 15 percent or maybe increased to 35 percent, but they cannot decide how taxpayers are going to behave if you have a 2.5 percent audit coverage rather than a 1.2 percent audit coverage.

The direct yield is something that we take into account in the process, but it is not the direct yield that is important. It is the effect upon the other taxpayers, upon the many who do comply, in knowing that those who would shirk their responsibilities are going to be called on to meet them. That is what is important.

Finally, I agree completely with Jerry Kurtz about the need for Internal Revenue to be able to employ and retain good people. Our tax laws are so complicated, that I do not understand why someone hired by the Service to answer complex questions on the telephone is paid less than a living wage, paid less than a trash collector in New York, and why a senior Internal Revenue executive in the chief counsel's office retires at the end of his long career at a salary less than a first-year associate in a New York law firm is being paid.

We should not try to equalize, but that gap, that particular gap, is increasing to a very great and very troublesome extent. Thank you.

Chairman CHILES. Thank you.

[The prepared statement of Mr. Alexander follows:]

HEARING ON THE TAX GAP
COMMITTEE ON THE BUDGET, UNITED STATES SENATE

STATEMENT OF DONALD C. ALEXANDER

MARCH 31, 1988

STATEMENT OF DONALD C. ALEXANDER
BEFORE THE
COMMITTEE ON THE BUDGET, UNITED STATES SENATE
MARCH 31, 1988

My name is Donald C. Alexander, and I am a partner in the law firm of Cadwalader, Wickersham & Taft. I am appearing, solely in my personal capacity, at the request of the Committee.

It is gratifying for a former Commissioner of Internal Revenue to see the interest of the Senate Budget Committee in the measurement, significance and components of the tax gap and the efforts and capability of the Internal Revenue Service to narrow the gap. Narrowing the tax gap would go far toward reducing the huge deficits that the Federal Government has been suffering in recent years. Since I lack both the elements (staff and access to data) necessary to respond fully to the issues developed in the Committee's letter to me, I will comment only on a few aspects of the problem.

I. The "Tax Gap" and What it Means

Two weeks ago the Internal Revenue Service produced a revised estimate of the tax gap employing recent studies and revised methodology. I am certain the budget committees, the tax writing committees, and the appropriation committees will subject this analysis to searching examination.

An initial question is what is meant by "tax gap". One would assume that "tax gap" was the excess of all taxes for a particular year over what was actually paid. However, the

Service's gap is the excess of what should have been paid over what was voluntarily paid, and as pointed out below, it is incomplete.

Many speak of our tax system as voluntary. It is not. A citizen or resident cannot elect out.

What is meant by "voluntary" in this context is that our taxpayers voluntarily self-assess themselves by filling out, executing and filing their returns. By analogy, most people comply with the traffic laws,[1] but this doesn't mean that our traffic laws or our tax laws are voluntary and that compliance is at the whim of the individual.

We don't have a voluntary system, but we do have a system of voluntary compliance. And voluntary compliance works well, so long as most of the individual income tax is withheld at the source of payment, and much of the remainder is the subject of information reporting. Compliance doesn't work well at all for individuals when there is neither withholding nor information reporting. As to corporations, the situation is different. An adequate level of compliance depends upon adequate and effective examination (and collection) capability in the Service.

II. Gaps in the Gaps

The Service has made it quite clear that its determination of the tax gap is incomplete; the gap of $85 billion recently announced by the Service as for 1987 does not include excise or employment taxes nor does it include taxes from the illegal sector of the U.S. economy. Employment taxes represent a very significant portion of the overall tax revenues of the United States; in 1986, employment taxes amounted to $243 billion or 35 percent of net tax collections, and excise taxes amounted to a further $33 billion or five percent of net collections. If the gap fails to take into account both unpaid employment and excise taxes, clearly there is a gap within the gap.

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[1] Except, of course, double-parking motorists, jaywalking pedestrians, and all bicycle messengers in Washington, where compliance with traffic laws appears to turn on personal choice.

Moreover, we all know that compliance with the tax laws by those who make their living by illegal means is likely to be low indeed. Although the Internal Revenue Service is in no position to measure the taxes that the illegal sector should have paid but didn't (if it could measure this gap, it could probably do something about it), a recent estimate puts annual revenues from the drug trade at $100 billion. Much of this is profit and it is rarely taxed.

Therefore, using IRS' current estimate of a portion of the gap, we find an aggregate gap of substantially more than $100 billion in lost tax revenues. If half of this could be collected, our national deficit would be much more manageable.[2]

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[2] Of course, there is a considerable difference between taxes assessed and taxes collected. A remittance gap of $7 billion is discussed in the IRS' March 1988 study. The amount of unpaid and overdue taxes is much larger.

III. Measurement Problems

That the amount of the tax gap is hard to estimate and the gain from strengthening IRS resources to combat it is equally hard to estimate should not inhibit efforts to produce useful estimations. The behavior of taxpayers, whether in response to economic or tax law changes or in response to strengthened or weakened administration of the tax law, is necessarily less than certain. Reasonable experts can differ, and they frequently do; a current example is the difference of view on the effect of reducing the capital gains rate.

Perhaps my perception is wrong, but there appears to be on the part of some a greater demand for exactitude in predicting taxpayer response to administrative changes than that required to predict response to structural changes. If this perception has any foundation, I am at a loss to understand why a higher standard of proof may be required to produce an estimate of the direct and indirect effect of strengthening enforcement than that required to produce an estimate of a structural change.

For example, it strains credulity to suggest that taxpayer service does not at least pay for itself in increased compliance. Surely taxpayer service prevents erosion of the tax base that would take place but for its presence. I think the Service is reasonable in estimating that its taxpayer service program prevented a potential revenue loss of nearly $1.3 billion in 1986. As Assistant Secretary Chapoton stated in his March 14 testimony before the Senate Oversight Subcommittee: "In addition, taxpayer service programs can promote accuracy and reinforce positive efforts by taxpayers to abide by the laws."

IV. Effect of Recent Legislation

The IRS has stated that recent legislation has reduced the opportunities for overstatement of credits and deductions and therefore, has tended to reduce the tax gap. Moreover, the reduction in marginal rates may make tax gamesmanship less rewarding. Nevertheless, the states' experience would suggest that taxes imposed at very low rates encounter much avoidance in gray areas, particularly when there is little enforcement. Moreover, while the investment credit and various deductions are now creatures of the past, other compliance-defying provisions have sprung up in their place. I am not optimistic about the 1986 Act's curtailing noncompliance; while many steps have been taken in the right direction (lower rates, base broadening, and reduction of tax preferences), many have been taken in the wrong direction (alternative minimum tax, passive loss rules, schedular interest deductions). Therefore, perhaps unlike others, I am not optimistic about the gap's closing by reason of tax reform. Also, frequent changes in the Code compound the problem. It might be accurate to say that continuation of our recent practice of annual model changes in the tax system will produce a Code that is almost compliance-proof.

V. IRS Resources

It is no news to you on the Senate Budget Committee to hear that the Internal Revenue Service was neglected for years.

The examination rate dropped in half, collections suffered, taxpayer service withered and returns processing was squeezed until the disastrous filing period of 1985. Under the leadership of Commissioner Gibbs, however, matters have greatly improved. Congress has been providing additional resources to the Internal Revenue Service and I believe that Commissioner Gibbs has been allocating these resources wisely and soundly. No more does one hear that the only taxpayers examined are those who invested in tax shelters -- an open invitation, if there ever was one, for tax avoiders to game the system through means other than shelters.

A problem in assigning examination resources to areas in which the marginal yield is greatest is that such assignment overlooks the need to maintain a reasonable and effective presence in areas where revenues are large but compliance must be maintained. Some estimates of the effect of increased examinations include only the direct yield reasonably expected to result from such activity. As Jeffrey Dubin, Michael Graetz and Louis Wilde point out, to fail to include a prediction of the general deterrence effect of increased audits is incorrect.[3] Therefore, it is important to have a meaningful audit presence in all significant categories of taxpayers and taxes.

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[3] Dubin, Graetz and Wilde, *Penny-Wise and Pound-Foolish: New Estimates of the Impact of Audits on Revenue*, Tax Notes, May 25, 1987.

A further problem is the great difficulty that the Internal Revenue Service faces in competing for the employment and retention of qualified people. It simply doesn't pay enough. How can someone whose salary is so low as to be eligible for food stamps be expected to answer all the complex questions thrown at taxpayer assistance during the current filing period? When a senior IRS attorney in a managerial position retires at a final salary lower than that paid a first-year associate lawyer in private practice, isn't something wrong? While it is impossible for Government salaries to be fully competitive with those paid in the private sector, it should surely not be impossible for there to be a more reasonable relationship between the salaries paid to Service personnel and those paid to their counterparts in accounting firms or law firms. Also, the Service should have a two-year budget in order to plan and hire as effectively as possible in these difficult circumstances.

VI. Conclusion

Thank you for the opportunity to present these random thoughts. I look forward to our discussion.

Chairman CHILES. Thank you. Ms. Stathis.

We want to thank GAO for being here, and for the work that you have done in this area as well.

STATEMENT OF JENNIE S. STATHIS, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, GENERAL ACCOUNTING OFFICE

Ms. STATHIS. Thank you for inviting me. I too will submit my statement for the record.

Chairman CHILES. Fine.

Ms. STATHIS. And I will simply summarize some of the main points in it.

Chairman CHILES. Thank you, ma'am. We will place that in the record.[1]

Ms. STATHIS. We believe that the purpose for estimating the tax gap is to gain some perspective of the magnitude and type of taxpayer noncompliance, and given that that is the purpose, we believe that IRS is to be commended for its effort in coming up with these estimates.

And we have some information in the beginning of our statement that parallels what you just heard from Jerry Kurtz, and you heard somewhat from Commissioner Gibbs, that these are just estimates, and that the estimates always carry with them lots of assumptions and they can be debated and discussed, but the main point is that the gap does continue to be large, and therefore invites some attention to the enforcement programs that are geared to get at various pockets of that gap.

I think the commissioners also explained, fairly well, that this is a bottoms-up estimate, and that when you do an estimate in that way there are a variety of certainties amongst the various pockets.

Some parts of the gap, like what IRS calls the informal supplier income, very difficult to estimate. And therefore, we should not put as much confidence in that part of it. But having said that, that also indicates that some pockets of this gap are more difficult to go after than other parts, but we do believe that IRS should strive to develop methods to get at all pockets of the gap.

Over the last few years we have made a number of reviews that would assist IRS in going after various segments of the tax gap and our testimony today illustrates three of those reports.

One discusses the merits of establishing a business information returns program. As Jerry Kurtz just explained, the segments of the gap where there is an information reporting program have a higher compliance rate than those that do not. Therefore, there is some merit to trying to develop more of those programs where it makes sense to do so.

The second study we discuss is one on tip income noncompliance, and the third one we discuss is the effectiveness of the enforcement program for the illegal-source income, which, too, is a very difficult pocket of the tax gap to go after.

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[1] See p. 345.

So, in summary, I would say that we are discussing ways that IRS could more effectively go after pockets of the gap with the resources that IRS currently has.

I, too, will be happy to respond to questions, Mr. Chairman.

Chairman CHILES. Thank you very much.

[The prepared statement of Ms. Stathis follows:]

United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
10:00 a.m. EST
Thursday
March 31, 1988

The Tax Gap

Statement of
Jennie S. Stathis, Associate Director
General Government Division

Before the
Senate Budget Committee

THE TAX GAP

SUMMARY STATEMENT OF
JENNIE S. STATHIS
ASSOCIATE DIRECTOR
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

The Internal Revenue Service's (IRS) objective for developing tax gap estimates is to gain some perspective on the magnitude and types of taxpayer noncompliance. IRS defines the "tax gap" as the difference between the amount of income taxes voluntarily paid by individuals and businesses and the amount of income taxes that are owed. IRS estimates that taxpayers will not pay $84.9 billion in income taxes that they owe on income derived from legal sources for tax year 1987.

Tax gap estimates can always be debated because of data limitations and different assumptions used in developing them. It is difficult to develop the estimates; and IRS is to be commended for the effort it has made.

IRS has not made public the complete details of the assumptions, methodologies, and data used in arriving at its latest estimates. However, by reviewing the current and previous IRS tax gap studies and by interviewing IRS officials, GAO identified some issues which can affect the size of the estimates. For example, (1) IRS based its estimates on existing data, but some of that data was old; and (2) some types of taxable income, such as income received on a cash basis through informal arrangements--informal supplier income--are very difficult to estimate. Even so, the tax gap estimates provide perspective on the size of the overall tax gap and identify pockets of noncompliance where IRS enforcement actions can be focused.

GAO recognizes that income from some pockets of the gap are more difficult to identify than others. However, IRS should strive to develop methods to get at all pockets of the tax gap. Over the last few years, GAO has reviewed several IRS enforcement programs and made recommendations and suggestions for program improvements. For the most part, IRS officials have been receptive to GAO's recommendations.

GAO's testimony illustrates how three of IRS' enforcement programs can be more effective in reducing the tax gap without significantly increasing IRS' resources. This testimony discusses: (1) the merits of establishing a business information returns program, (2) the adequacy of IRS' efforts to address tip income noncompliance, and (3) the effectiveness of IRS' primary enforcement program for illegal source income.

Mr. Chairman and Members of the Committee:

We are pleased to be here to discuss the tax gap and our efforts over the past several years to help the Internal Revenue Service (IRS) narrow the gap. We have been concerned about the size of the tax gap and have reported and testified on the need for IRS to take actions to better identify unreported income and collect the taxes owed the federal government. In this time of difficult choices in deliberations over the federal budget, closing the tax gap in a cost-effective manner is more important than ever. By collecting more taxes that are properly due, IRS can make contributions to lowering the federal budget deficit.

Today, Mr. Chairman, I would like to make two major points:

-- First, it is difficult to precisely measure the tax gap, but IRS' estimates show that the tax gap remains substantial.

-- Second, IRS can do more to reduce some parts of the tax gap. Our recommended improvements to several IRS enforcement programs should enable IRS to better identify unreported income and collect more taxes.

Mr. Chairman, I would now like to discuss these two points in greater detail.

THE TAX GAP ESTIMATES

IRS' objective for developing tax gap estimates is to gain some perspective on the magnitude and types of taxpayer noncompliance. IRS has issued three studies, in 1979, 1983, and 1988, on tax gap estimates. The estimates in these studies can always be debated because of data limitations and the different assumptions used in developing them. However, available evidence suggests a noncompliance problem in the billions of dollars, underscoring the need for effective IRS enforcement actions.

In order to understand IRS' most recent estimate, which was released in March 1988, it is important to understand what the estimate includes and excludes. IRS defines the "tax gap" as the difference between the amount of income taxes voluntarily paid by individuals and businesses and the amount of income taxes that are owed. IRS estimates that taxpayers will not pay $84.9 billion in income taxes that they owe for tax year 1987. This amount is for income derived from legal sources because the 1988 study did not include an estimate for illegal source income, as did the 1983 study.

IRS divides the legal source income tax gap into two parts: individuals and corporations. The individual tax gap includes sole proprietorships and partnerships. For 1987, the tax gap for individuals is estimated to be $63.5 billion, or about 75 percent of IRS' latest tax gap estimate. The tax gap for corporations is estimated to be $21.4 billion, or about 25 percent. In the 1983 study, the individual gap was estimated to be 92 percent and the corporation gap 8 percent.

The individual tax gap includes estimates for those who file incorrect tax returns as well as those who do not file at all. Of the tax gap for individuals who file returns, unreported income at $48.3 billion is the largest single portion. Unreported income can come from many sources such as wages and salaries, interest and dividends, sole proprietorship income, capital gains, and what IRS calls informal supplier income. Informal supplier income is cash income received by individuals through informal arrangements, such as those for some home repairs or day care. The largest portions of unreported income, according to IRS' study, are from sole proprietorships, informal suppliers, and capital gains, which are 34, 16 and 14 percent of the $48.3 billion total, respectively.

The corporation tax gap, from underreporting income and overstating deductions and credits, includes an approximate $16 billion tax gap for large and medium corporations--those with $10 million or more in assets--and about a $5 billion tax gap for small corporations--those with less than $10 million in assets.

IRS has not made public the complete details of the assumptions, methodologies, and data used in arriving at its latest estimates. However, by reviewing the current and previous IRS tax gap studies and by interviewing IRS officials, we identified some issues which could affect the size of the estimates.

-- First, IRS based its estimates on existing data, but some of that data was old. IRS used 1972 and 1977 data to estimate the amount of income that should have been reported by individual nonfilers. To estimate the amount of underreported income from taxpayers who filed, IRS relied on the results of its Taxpayer Compliance Measurement Program examinations of 1982 individual returns. For small corporations, IRS used 1981 program data.

-- Second, IRS' assumptions and methodologies could affect the size of the tax gap estimates. For example, IRS assumed in its latest study that overall compliance would remain constant through 1992. This assumption was based in part on the results of examinations and the potential impact of changes in the tax laws since 1982, including the significant changes from the Tax Reform Act of 1986. In its 1983 study, IRS assumed that compliance would decline because voluntary compliance rates were down. IRS' current study is not clear on how much this change in assumption affects the tax gap estimates or IRS' projections of those estimates.

-- Third, IRS' published estimates of the legal sector gap are on a recommended basis; that is, they include some taxes that would be recommended by IRS' examiners, but which would not be assessed if successfully appealed. As the IRS study explains, on an assessed basis, the tax gap estimates are lower.

-- Fourth, IRS has excluded items from its 1988 tax gap estimates that it previously included in its 1983 study. As previously stated, IRS excluded any estimate for illegal source income from the 1988 study. In the 1983 study, IRS estimated a $9.0 billion tax gap for 1981 from 3 illegal activities--gambling, drug trafficking, and prostitution.

-- Fifth, some types of taxable income are very difficult to estimate. The $7.7 billion estimate for informal supplier income is based on data gathered from individuals about the extent to which they purchased various items or services from street vendors or others on a cash basis. From this data, IRS attempted to estimate the amount of unreported informal supplier income, making various assumptions about applicable tax rates, deductions, etc. of the individuals receiving this income.

Further, IRS is already collecting a portion of what it considers the overall tax gap. IRS' own definition of the tax gap includes all income taxes not voluntarily paid, but owed. Thus, all the amounts IRS collects through enforcement programs, like the examination of tax returns, could be deducted from IRS' estimate to arrive at a net tax gap. For example, if IRS enforcement programs resulted in several billion dollars in additional taxes collected, and this amount were applied to the tax gap estimate, the tax gap would be reduced by the taxes IRS collected.

The issues associated with developing tax gap estimates make it difficult for Congress to have a firm base from which to measure the overall impact of IRS' enforcement programs in reducing the gap. Developing these estimates is difficult, and IRS is to be commended for the effort it has made. The tax gap estimates provide perspective on the size of the overall tax gap and identify pockets of noncompliance where IRS enforcement actions can be focused.

IRS CAN TAKE ADDITIONAL STEPS TO CLOSE THE TAX GAP

Some types of unreported income, such as wages, interest, and dividends, can be more easily identified than others through IRS enforcement actions. Other types of unreported income, such as informal supplier and sole proprietor income, as well as income illegally obtained, are more difficult to identify, and thus taxes are more difficult to collect. Even so, we believe that IRS should strive to develop methods to get at all pockets of the tax gap.

Over the last few years, we have reviewed several IRS enforcement programs that are designed, in part, to reduce the tax gap. We have made various recommendations and suggestions for program improvements, some of which could be made without significantly increasing IRS' resources. For the most part, IRS has been receptive to our recommendations and has either taken action or plans to take action on them. Attached to this statement is a list of reports and testimonies on selected reviews of IRS' enforcement programs. Three of those reviews illustrate how IRS' enforcement programs can be made more effective in reducing the tax gap.

In 1987 we testified on the merits of establishing a business information returns program. This program would be similar to IRS' information returns program for individuals, which is designed to detect unreported income. IRS matches income, such as interest or dividends, reported on information returns it receives from banks and other payors against income reported by individual taxpayers on tax returns. IRS considers this matching program for individuals a successful enforcement program, and IRS officials said it yielded $17 in tax assessments for every $1 in cost to IRS in 1985.

Although IRS received about 31 million information returns for businesses in calendar year 1986, it had not established a matching program for businesses. We concluded in our testimony that IRS could initiate a matching program to identify unreported income of sole proprietorships and to identify business nonfilers. We also suggested alternatives to IRS to help overcome impediments associated with establishing a full-scale matching program for partnerships and corporations. Not all proprietorship and business income is subject to information reporting. However, we believe that portions of the currently estimated tax gap of $16.6 billion for proprietorships and $21.4 billion for corporations can be reduced through cost-effective matching programs. IRS is testing the feasibility of an information returns matching program for identifying unreported income of sole proprietorships and for identifying business nonfilers. IRS is also testing the use of information returns to detect unreported corporate income.

In 1986, we reported that tip income reporting could be increased. For calendar year 1981--the latest year for which information was available--IRS estimated that individuals did not report or pay taxes on over $8.5 billion in tip income. This unreported income translated into an estimated tax loss of $2.3 billion. IRS further estimated that the tip income noncompliance rate was about 84 percent, the highest noncompliance rate among all legal source income areas.

We identified tip income detection methods that were being used in some IRS regions but not in others. We pointed out this inconsistency as well as the need for an overall strategy to reduce unreported tip income. IRS officials generally agreed with our recommendations and identified activities that IRS had underway to aid in the formulation and implementation of an overall strategy. One of the activities included a congressionally mandated study of tip income noncompliance that, among other things, will provide information on the nature and level of tip noncompliance. This study is expected to be issued this summer.

With respect to IRS' efforts to address the illegal source income tax gap, we will soon issue a report on IRS' Special Enforcement Program--its primary means of detecting illegal source income. This program seeks to prosecute major criminals for tax law violations and tax the proceeds of illegal activities, thus making them less profitable. Our work showed that for the program cases closed in 1982--the latest data available--IRS collected about $11 million, of which $2 million represented taxes on illegal income. While we agree with IRS that it is difficult to identify and tax illegal source income, we believe that IRS could do more to address the tax aspects of criminal cases. IRS officials informed us that in order to ensure more effective tax assessment and collection, they plan to implement a district level program to monitor civil actions on closed criminal cases.

We are currently doing other work related to reducing the tax gap. At this committee's request, we are reviewing how much revenue IRS actually generates through examinations. We are also looking at the effectiveness of IRS' efforts with regard to independent contractors' compliance with the tax laws, the adequacy of levies to promote better compliance, and the effect that past declining audit coverage may have had on the tax gap.

We have recognized the importance of IRS having adequate resources to maintain effective enforcement programs. We have testified on IRS' budget requests and recommended that IRS be given additional resources, which Congress has provided. We also believe, however, it is incumbent upon IRS to continue to identify those opportunities and innovative techniques that will enhance the effectiveness of its enforcement programs in reducing the tax gap.

This concludes my prepared statement. I would be happy to answer your questions.

SELECTED GAO REPORTS AND TESTIMONIES SINCE 1981 ON IRS ENFORCEMENT PROGRAMS

Investigating Illegal Income--Success Uncertain, Improvements Needed (GAO/GGD-88-61, issuance due in spring of 1988)

Gas Guzzler Tax Compliance Can Be Increased (GAO/GGD-87-85, 7/16/87)

Testimony Before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations on The Merits of Establishing a Business Information Returns Program (GAO/T-GGD-87-4, 3/17/87)

Tip Income Reporting Can Be Increased (GAO/GGD-86-119, 9/30/86)

Information Returns Should Increase Proper Reporting of Farm Income (GAO/GGD-86-69, 7/22/86)

Testimony Before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations on IRS' Information Returns Matching Program, 4/29/86

Protecting Tax Revenue When Businesses File for Bankruptcy (GAO/GGD-86-20, 2/21/86)

The Federal/State Tax Information Exchange Program (GAO/GGD-86-8, 12/13/85)

IRS' Examination Selection System for Exempt Organizations' Unrelated Business Income (GAO/GGD-85-64, 7/8/85)

IRS is Taking Action to Improve the Quality of Its Small Corporation Audits (GAO/GGD-85-26, 6/12/85)

Testimony Before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations on U.S. Citizens Living in Foreign Countries and Not Filing Federal Income Tax Returns, 5/8/85

Administrative Changes Could Strengthen IRS' Claims for Rewards Program (GAO/GGD-85-11, 4/19/85)

Further Research into Noncompliance is Needed to Reduce Growing Tax Losses (GAO/GGD-82-34, 7/23/82)

What IRS Can Do To Collect More Delinquent Taxes (GAO/GGD-82-4, 11/5/81)

IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (GAO/GGD-81-81, 9/30/81)

Chairman CHILES. Senator Conrad.

Senator CONRAD. Well, first of all, I want to thank the Chairman, and Ranking Member for holding this hearing. It deals with issues that I've regarded as very important since I arrived in Washington. I have been so convinced we had a major opportunity here. If you have got a problem, we have got a major opportunity, and I think we have laid the evidence on the table here today, and I want to very much thank all of the witnesses.

Let me ask Commissioner Gibbs, and perhaps Mr. Alexander or Mr. Kurtz would want to comment. My understanding is that your current estimate of the rate of return for every dollar invested in examination would be $15, and for collections, a $20 return for every dollar invested.

Are those current numbers?

Commissioner GIBBS. The total average return for the IRS' revenue enforcement programs is a $20 return for every dollar invested. The return at the margin of course is somewhat smaller.

Senator CONRAD. All right. I just think we want to make that point, that based on the history, you have got a very strong rate of return for every dollar invested in these activities. Let me go further. We talk about the need for service, and I want to associate myself with the remarks of Jerry Kurtz—I think he is exactly right—and the remarks of Don Alexander, that the service component is critically important.

One of the things we did with the fair share program we put together in North Dakota in 1981 was to emphasize good service to taxpayers. Let me just ask: what is the current mail backlog at the Internal Revenue Service.

Commissioner GIBBS. Our current backlog is in a variety of places. I do not have precise numbers on it. We try to answer letters within a 15-day period. To be honest, we are not always successful, and particularly, at certain times of the year in our service centers or our national office in answering letters within that 15-day period.

The mail is a problem for us, and I will be happy to submit for the record a breakdown of what we have in the way of backlogs from time to time, to give you some idea of where it is in various places within the organization.

Senator CONRAD. Mr. Kurtz, or Mr. Alexander, in your experience—not commenting on the current situation—but in your experience, would you want to comment on what the mail backlog was.

Mr. KURTZ. Well, it has always been a problem and it is a problem not just of a delay in answering, but it is a problem of straightening out the problems that the letters address.

That is, someone writes in about a bill or something. It is a function, both of the way the computer system works, and its problems, that it is very difficult to get those problems straightened out. While this has always been a problem, my sense is it is a growing problem.

A few years ago I think it was much worse than it was 10 years ago. Apparently the situation has improved a little bit recently.

Ms. STATHIS. I do not have any statistics on the backlog at the moment. I was just going to give a plug to the commissioner's quality program.

You know, quality really affects all of these various IRS backlogs, by which I mean that if a process is done correctly the first time, and the taxpayer understands it correctly the first time, that there will be no need for them to write in or to call in.

So I think that the commissioner's effort to institute a quality program throughout the service, that would have an emphasis on doing things right the first time is very important.

Senator CONRAD. Might I ask another question, Mr. Chairman, that I think goes to the question of pay.

Commissioner Gibbs, Mr. Alexander and Mr. Kurtz, are you familiar with any rate-of-return studies on auditors with different levels of experience?

That is, have you measured the productivity in terms of return to the government for additional auditors of varying levels of experience?

The reason I ask that question is we did that kind of study in North Dakota and we found a very remarkable thing. If you look at auditors with more than 2 years of experience, there is a very dramatic break between those, and auditors with less than 2 years of experience, and we found another break at about 4 years of experience—just a dramatic difference in the kind of return that they would bring.

And I know there are many difficulties in making that kind of analysis because you have got to look at the kinds of audits that are being assigned.

But have you done that kind of analysis?

Commissioner GIBBS. Mr. Conrad, let me respond generally to that. We do believe that our more experienced auditors are more productive.

For example, we tend to have our more experienced auditors in the coordinated examination program that audit large corporations.

We also believe, from experience, that as our agents become more experienced in the examination area they become more productive.

Quite honestly, with the concern that has been expressed over the years with respect to quotas, we do not track, from a statistical standpoint, the productivity of particular agents, or even particular groups of agents for that reason.

But we do believe, from the standpoint of looking at gross numbers—not looking necessarily at productivity on the individual level—but when you look at the various programs that we have, and the experience of the people in the programs, and the dollars the programs are producing, it would certainly tend to support what you are saying.

Mr. ALEXANDER. That was certainly true, Senator Conrad, when I was around the tax shop, but again, as Commissioner Gibbs pointed out, we did not want to keep any statistics which might carry the scent of a quota system.

Mr. KURTZ. I would say the same thing. I mean, any attempt to accumulate those statistics by revenue production, by particular revenue agents, and Larry would be here at another hearing before another committee.

Senator CONRAD. Let me just say we had no quota system. But we were very interested in measuring the productivity of agents based on experience, and the conclusion that we came to was that you were much better off to move people up quickly in terms of pay, in order to retain them, than to lose those people right at the critical times when they were becoming most productive.

And I would assume, we might find a similar situation if we were able to do such a study at the Federal level. And again, I do not think that having this analysis means that the revenue service intends to institute a quota system.

I think we are all in agreement on that principle. But I think we would find the same thing, and I think what you are saying confirms that we are penny-wise and pound-foolish when we do not pay these people sufficiently to keep the good ones. Our whole system is damaged as a result.

And really, the people who ultimately pay the bill are the honest taxpayers. The honest taxpayers pay because they are already paying their share, and those who are not get off, and if we do not find the revenue from those folks it turns into deficit which will be collected in the future from the honest taxpayer.

So I hope that we make that point clear here.

Mr. KURTZ. Senator Conrad, may I make a suggestion.

Obviously that is a very worthwhile idea, and it is a study that really ought to be done. I think it will be very useful. I am troubled with the IRS doing it. I would suggest GAO do it.

Senator DOMENICI. That is great.

Senator CONRAD. Yes; I think that is something that is really worth doing. I would not even ask Commissioner Gibbs if he would be receptive of that kind of thing.

Chairman CHILES. Let's see if Calhoun wants that ball.

Ms. STATHIS. As you know, we are currently doing a study for the Senate Budget Committee on the exam model, the estimate of the yield that you receive from increased exam resources; and there is some estimate used in that model, that factors in a new revenue agent versus an experienced one, and I am not sure exactly what that is or how it works, but we will be happy to give uou information on that.

So there is some estimating of that at the current time.

Chairman CHILES. Senator Domenici.

Senator DOMENICI. Thank you, Mr. Chairman.

Might I ask the panel, just quickly: is there some evaluation of the pay situation within IRS that we might avail ourselves of? Is there a study that does a good professional evaluation of the pay scale changes that might be needed in order to accommodate the efficiencies that have been discussed here?

I mean, frankly, I believe while we are so concerned now about the tax gap, it might be well be the right time to address the issues of the professionals within the department, and the pay and equity.

I mean, I have heard a number of you say wages do not have to match the marketplace, but when a gap is so big that it becomes almost impossible to continue to justify working for the Federal Government in this complicated area, it is time to take a closer look at the problem.

And frankly, I think we might tie the two together, enforcement enhancement with some new approach to a type of pay scale in the various areas that is justified.

If you wondered what I was whispering to the Chairman, I was asking him whether he thought a new IRS pay scale would stand on its own vis-a-vis the rest of government. Maybe it might in the context of closing the tax gap, and I personally think we could find a lot of people interested in something like that, if we could get higher pay.

Commissioner GIBBS. Senator Domenici, I would be delighted to try to provide something to the committee. We do have some information in various places, and I understand your concern about self-serving. I would be delighted to work with the GAO to provide you something, so that you would have some confidence with respect to where we are deriving the numbers, if that would be appropriate with you and with them.

But we do have some information that I think we could present.

Senator DOMENICI. Well, if the GAO can do a study it would make it a little bit less self-serving of one department versus the rest of government, and I do not know where it would end up.

You know, we have scientists in other agencies, and we are having the same problem. Engineers and auditors for the Department of Defense, and we know a lot about how hard it is to keep them, too. They are our there competing in an enormously complicated environment, and we are losing them all the time. They are out there auditing big business, and they are being paid $28,000 to live in New York for 6 months while their family is in Albuquerque, NM.

But if we could just tie this IRS pay issue in a package it might be a star.

Ms. STATHIS. I was going to say, Senator, that in a report that we gave to this committee in December on the 1987 revenue initiative, we have a small piece of information, and that has to do with entry-level salaries for revenue agents. It is on page 6 of that report.

But as you alluded to, it is a bigger problem than just entry-level salaries for accountants. It applies to a lot of other technical skills.

Chairman CHILES. Well, I think it would be interesting if you could work with the Commissioner, if you could get us a little something. Of course time is of the essence in something like this.

Ms. STATHIS. We will be happy to do that.

Commissioner GIBBS. We will be glad to, Mr. Chairman.[1]

Senator DOMENICI. Let me ask if there is any information that any of the panel has on this. I have heard, that while the United States of America, relying upon a volunteer tax system which for most of its existence was a model for the world, and is still pretty good when compared with our industrial competitors such as France, West Germany, Japan, and the like. We have problems, like lack of compliance. Our compliance is not all that bad vis-a-vis our major competitors.

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[1] The information referred to is retained in the files of the committee.

Does anybody have just a general response answer to that? I once heard that France had gotten to the point where their laws were so complicated, that as a matter of fact, other than for very modest taxpayers, taxpayers figured they did not even have to file because it was so complicated. They would meet table to table with an agent, negotiating out what they owed.

I heard that 10 years ago about France. Clearly, if that is the case, or even close to that anywhere in any other countries, they are not going to get any better compliance than us.

Mr. Kurtz. Well, my impression is there are very few places, if any, in the world, that have better compliance with a broad-based individual income tax than we have. Canada, I think, runs a very efficient system. I think the Scandinavian countries, by and large, run very efficient systems. West Germany has a good system.

The French system is different. In a sense a number of things are based on value, so that there are negotiations. Their income tax in some respects is like our estate tax.

Let me say that I think tax systems in the industrialized world have gotten a lot better. Our system works best because of the widespread withholding and matching.

If you look at the small business person in the United States—when I say small, I mean really small, the individual proprietor—compared to the individual proprietor in other countries, I am not sure there is a dramatic difference in compliance.

Senator Domenici. I do not want to spend an awful lot of time on this issue because I have two more questions, and I know the chairman is waiting.

Mr. Alexander. I just want to say that we might compare our system with the Italian system, where you often find the return being a first offer. At least where a material amount of income is subject to withholding, a material amount of income is subject to information reporting, the first offer syndrome is out.

Senator Domenici. You did not have to choose Italy for your example. [Laughter.]

Mr. Alexander. I should not have, but I was afraid of banging on France too hard, sir.

Chairman Chiles. And you did not have to choose France, either.

Senator Domenici. Well, I looked around here, and I did not think that would offend anyone. [Laughter.]

Now we have France and Italy taken care of, so let me ask this last question. I'll first say to our chairman, I really think this is a very good session, and I hope that we do not let what we are learning here disappear from the scene.

I do not know of any other committee that has enough time these days. They are jumping back from one tax-reform measure to a trade bill to this, that, and the other, and I do not know whether anybody is even hearing as much as this committee about the subject of the tax gap.

So I think we ought to try to do something with it. Having said that, can you clear up for me, Commissioner Gibbs, when I listed the numbers and the percentages that you gave us, it seems to me that the largest known portion of the tax gap is still plain old math errors, mistakes reported by American citizens in their return.

I used the word "erroneously prepared." You used "understating of income" in the generic sense, which could be both income, or overstating the things you subtract from income.

Is that true, that that is the biggest piece, and if it is, that is not fraudulent, as I understand it? It is just mistakes?

Commissioner GIBBS. Let me see if I can explain it, Senator Domenici.

We know that the failure to report all of the income that should be reported by individuals is the single biggest element. Now what you are getting to is why didn't they report the income?

Did they do so consciously? Did they do so by mistake?

Senator DOMENICI. Right.

Commissioner GIBBS. That is a much more difficult thing to measure. It is made up of both of those, and what I am simply suggesting is that in the past, we have tended to look at the tax gap as people who intentionally understate their income.

I am suggesting, and I think it is a theme that began with the beginning of our hearing this morning, with Mr. Dorgan, that I think we have underestimated people's ability—not their willingness to comply in terms of their understanding of what their tax obligations are, not for a second saying that we do not have people who are unwilling to comply and understate their income consciously.

I am simply saying that you need a balanced approach to basically find the folks that are unwilling to comply and make them comply, but help the people that are trying to comply and are having trouble doing so.

Senator DOMENICI. My last question is twofold. In the evidence you are accumulating, did I read you all right, that we have no real evidence that there has been an attitudinal change of measurable proportions on the part of the American people with reference to paying their taxes?

Commissioner GIBBS. This was mentioned, and let me verify what Mr. Kurtz and Mr. Alexander have said.

The tables that you saw in our studies do not take into account behavior, changes of attitudes or behavior. They are statistical analyses across the elements that we use in our methodology.

So we cannot tell you that there has been a change. I will tell you, personally, that I think with respect to the tax gap as a whole—remember, I said it was composed of three elements—our prior analyses tell us that about two-thirds of the tax gap was in such small amounts involving so many people, that it is simply not cost-effective to give us resources, at least on the compliance side, to try to collect that.

It is basically going to be a matter, I think, of attempting to change attitudes, and I honestly believe, providing service and assistance is a key element of that.

Senator CONRAD. Would the Senator yield on that point because I would just like to ask a follow-up.

One of the reasons I asked for this hearing is because I am so personally convinced from my own experience that we have an opportunity in front of us. And one of the reasons I am convinced there is an opportunity is because we have a chance here to alter opinions.

You have talked about service and providing assistance. I think that is a critical component. I also think it is a critical component that those who are dishonest, who are out there—and there are some—we all know that.

Senator DOMENICI. Who are what?

Senator CONRAD. Who are dishonest.

Senator DOMENICI. Dishonest.

Senator CONRAD. Corporations, and individuals who want to get by without paying their fair share of taxes. We need to change the perception that they have that they can get away with it.

And a critical component of what we did, and did successfully in the program we instituted in North Dakota, was to alter perceptions.

We started by saying, look, we are going to have a time-out period. If you have violated the law we are going to give you a chance to come in, pay what you owe, and pay the interest on what you owe. But after that time has expired we are going to have a new environment here, and those who are escaping paying what they owe as their fair share of this burden are going to get caught.

We publicized that effort heavily, and frankly, I am not at all certain that the increased publicity did not play as significant a role as the increased enforcement resources.

Obviously, I am convinced both are important. As we found when dealing with the drug menace, we have various elements. We need to educate, we need to help people, and we also need to put the hammer down on those who think they are going to get away with something.

I think we have got to do the same thing in this area, and I just wanted to not let the opportunity slip by to make that point.

Chairman CHILES. Senator Nickles.

Senator NICKLES. Mr. Chairman, thank you.

A couple of questions, Commissioner Gibbs, concerning the budget. What is the budget for IRS in 1988?

Commissioner GIBBS. The budget for this year is slightly in excess of $5 billion.

Senator NICKLES. What is it for 1989, proposed?

Commissioner GIBBS. For 1989, there is about—as I recall—about a $240 million increase for fiscal 1989. I believe that is right.

Senator NICKLES. $240 million?

Commissioner GIBBS. It is $5.3 billion versus almost $5 billion for 1988.

Senator NICKLES. I was looking at a figure but it also included some refunds which are added to the figures which you have mentioned. So, in looking at those figures, it went from $7.5 billion in 1987 to $10.9 billion in 1989 but that does include some refunding of IRS collections and interest, so that may not be the right——

Commissioner GIBBS. There are certain nonoperating accounts like interest that is paid to taxpayers, or earned income credit that would be included.

Senator NICKLES. But you have had some pretty significant increases in budget, if I recall. In past budget agreements, we have continued to put more money in, and said that it was going to be a net positive gain.

Is there a diminishing return? How far and how long can we carry that? I have heard presidential candidates say, well, they are going to go out and get this $100 billion.

I would think that there would be a diminishing rate of return, and I question how much additional money, et cetera, would be used in a way that would be very positive, without auditing every return and without being maybe overzealous.

Commissioner GIBBS. Senator Nickles, let me see if I can answer the question this way.

As you add additional compliance personnel to the Internal Revenue Service, the marginal rate of return goes down in terms of collecting taxes that are due, examining returns, and so forth.

But the actual limit on our ability to collect the money is basically a limit on how many people we can recruit, train, and deploy, at least for a fairly substantial period in the future.

We would estimate that in terms of cost effectiveness, you could perhaps add another 50,000 to 60,000 employees into the compliance side over a period of years, and it would still be cost-effective to do that.

Senator NICKLES. How many people do you have now?

Commissioner Gibbs. We have requested 113,811 average positions for fiscal 1989. For FY 1988, 112,161 average positions are authorized.

So we are talking about a very substantial increase in the size of the organization, if you simply look at cost-effectiveness.

Let me mention one other thing. Remember the comment that was made with respect to our audit coverage. Our audit coverage is now down perilously low, when you look across all of the income-tax payers, to 1 percent. That is a very low percentage in terms of what it was when Mr. Kurtz was there, when Mr. Alexander was there, and prior commissioners before them. It has been continually going down.

Obviously, as you go up in the income-tax brackets, for individuals and corporations, your chances of being audited are higher.

But by the same token, we are not anywhere close to where most people would feel we should be from an audit coverage standpoint.

Senator NICKLES. Mr. Kurtz, did you want to add something to that?

Mr. KURTZ. Yes; I just wanted to say that while theoretically each successive return audited produces less per manhour spent, that assumes a perfect selection process, and the selection process is not perfect. So there is no diminution at these levels of examination. To go from 1 percent coverage to 2 percent, or to 3 percent, will not produce any noticeable change in marginal yields, because the returns cannot be classified perfectly.

If we went to 10 percent or 15 percent, sure, you would begin to see declines in marginal yields, but I do not believe the service is anywhere near seeing any decline at all in——

Senator NICKLES. When you were commissioner, what percentage were audited?

Mr. KURTZ. About two and a half.

Senator NICKLES. Mr. Alexander, do you remember?

Mr. **Alexander**. 2.6 percent. Finally got it up to 2.6 percent in 1976. It went down slightly in the immediately following years, and then it had a precipitous decline later.

Senator **Nickles**. Commissioner Gibbs, would part of that decline be the fact that with the changes in the tax code we now require returns for minors?

This is a relatively new change, but you are going to have a tremendous increase in the number of returns that will be filed.

Commissioner **Gibbs**. Well, part of it obviously, since it is a percentage. As the number of returns goes up, if you keep the numbers of agents the same, your audit coverage will go down. In prior years, not in the recent past resources were added to maintain the audit coverage rates.

We simply have not been doing that over the last 10–15 years.

Senator **Nickles**. Let me ask you another question that is along that same line. We have required, in an effort to do what Mr. Kurtz had implied, to get more information—we now require employers to report all kinds of miscellaneous income, 1099s, et cetera.

Do you have the capability to keep up with that mountain of paperwork that must be coming in?

Commissioner **Gibbs**. Senator Nickles, let me put it in perspective for you. This year, we will receive in excess of a billion information documents that we will match, and, frankly, we will match in excess of 95 percent of that because it is being received in in magnetic media form, so that we can basically use it with our computers.

Now at one time there was a myth out there that people were sending paper in and the IRS was not able to process it and match it.

That is no longer the case because people are now sending it to us via magnetic media, and have been for quite some time. We also more sophisticated in using this information. And by the way, the funds that we receive are going into this program in very substantial amounts.

So we are able to take the billion pieces of information and match it to the returns, and we are doing it better each year, and we are doing it more extensively each year.

Senator **Nickles**. A lot of the information is di minimis, or the values involved are di minimis, and I question that. I will receive or maybe have a family member receive a 1099 for $2.49.

Think of the paperwork by the insurance company, or by whatever institution, and then the filing, and et cetera, and I question how expensive that is by the time it goes all the way through the process.

Maybe if you are dividing by a billion pieces it averages out, but I have wondered—surely, isn't there a better way?

Commissioner **Gibbs**. Well, remember, too, that we do have tolerances. We do not publish them, we do not put out a road map, but we do have tolerances below which we do not hassle individuals with very low amounts.

So if you are down in the several dollars range it is one thing, but frankly, our matching program has been one of our most productive programs.

And at least in terms of undergoing an audit, it is a less intrusive program because we largely conduct it by correspondence.

Now Mr. Kurtz mentioned—and I will be frank with you—we do need to improve our own procedures in terms of how we deal with people, as people find they are telling us no, I did include it in my return, you have not found it yet, it is an area where we need to improve our public relations aspects with taxpayers. But we are effective with it in terms of the dollar return.

Senator NICKLES. Let me echo and compliment you on your remark, and encourage you along that line.

I was recently—as I am sure my colleagues know—when we traveled around the State of Oklahoma, I was given a piece of paper where a person basically stated—it was very similar to an article that I think came out of Arkansas, where the person underreported $1 or $2, and then had a fine, penalty. In this Oklahoman's case, I have the return in my office as a matter of fact. The fine was $700.

The problem, as I could see it, is the interest and penalty, with no mention of where the mistake was made. And so I would very much encourage better communication, that maybe this payment was not made on time, or maybe it was late, or whatever the problem might have been.

But here you have a constituent who said, hey, I was $2 off, and here is my $700 penalty, with no real explanation. The same exact paragraph on the form really causes a lot of anxiety for those people.

Commissioner GIBBS. Senator Nickles, I understand that.

Let me comment about two aspects of it, because there has been some confusion.

There are two types of penalties. One is a penalty where you fail to pay the dollar amount that you should be paying. Another penalty is that you fail to pay the amount on time.

What we find with most of those notices is that the penalty does not relate to the dollar amount that was failed to be paid.

The penalty is imposed because it was not paid on time, and it is a percentage of the amount that should have been paid on time.

Now your point is, well, commissioner, that is fine, but I could not tell that from the notice.

Let me tell you that in our 1989 budget we have requested, the Administration has approved, and it is before you now, to permit us to have the money that we need to provide a better explanation for interest and penalties on our notices, and I hope we will get that because I agree with you, I think that has been a problem in the past.

Senator NICKLES. I think you do need it and I think that explanation needs to be made. And you mentioned penalties. You also mentioned the fact that some people might send in returns without sending in the payment.

Isn't there a 10 percent interest penalty or no-payment penalty? If the return is filed and an assessment is due, or underpayment is due, isn't there a 10 percent penalty?

Commissioner GIBBS. There is a penalty for failure to pay and it basically starts small and grows over a period of time and it can grow up to 25 percent over a period of time in terms of——

Senator NICKLES. Is it penalty or is it just interest?

Commissioner GIBBS. Well, it is a penalty amount for failure to pay. Now what you may be referring to is a situation where you have failed to properly estimate your taxes, and that is a penalty that is computed in the form of interest but it is not deductible. It is really a penalty amount. That is for a failure to properly estimate.

But if you do fail to pay your tax there is a penalty that accrues. On the other hand, Senator, it is really important at this time of year and we are explaining to people, that if for some reason they find when they prepare the return that they do not have the money to pay the tax, they really need to go ahead and file the return.

Because if they do not file the return then there are two penalties that are perpetually applied. So we suggest that they file the return, pay as much as possible, and then we are going to have special programs to deal with those folks, particularly the ones that, for some reason this year, have been caught short, in terms of exploring with them the various options that they have to pay.

Senator NICKLES. What type of flexibility do you have, i.e., let's take a constituent who owes $10 thousand, they can pay $5 thousand and need more time to pay the additional $5 thousand. Should they go down to the bank and borrow that $5 thousand, or if they put it in and say, with a notice, I will pay the additional $5 thousand within 90 days——

Commissioner GIBBS. Senator, if they are able to go down to the bank and borrow it, we will encourage them to go down to the bank and borrow it and pay us off, so that it is the bank and not the government that is the creditor.

By the same token, we will work with them in terms of looking at their financial statement, their other personal expenses, and so forth.

There are criteria to permit installment payments if that is appropriate, but from the standpoint of our collection approach it is basically to deal with each taxpayer as an individual and to take a look at the individual circumstances.

Senator NICKLES. I understand. My last comment. I heard Senator Domenici say that our system worked fairly well as a voluntary system. I do not think our system is voluntary. Mr. Alexander or—is it voluntary?

Commissioner GIBBS. Could I comment on that?

Senator NICKLES. Sure.

Commissioner GIBBS. I think indeed it really is a voluntary system. Let me explain what I am talking about.

Let's contrast it, for example, with the French system that was mentioned a minute ago. There are many, many countries in this world where the government comes out and tells you what you owe.

And I have mentioned, at an earlier hearing today, that next year, for the first time in our history, we will raise a trillion dollars, gross, in our tax system. That is a remarkable amount, but what is even more remarkable is we will pay $90 billion in refunds to individuals based on returns that they file and send to us, before we ever audit the accuracy, before we ever match anything, before we ever have our agents come out and so forth. $90 billion.

Now once that is paid out, $90 billion, then it is simply a matter of attempting to verify that in some way, and, frankly, the lesson, I think, with respect to the W4 problem of last year was that to a very large extent. If people do not understand the withholding system, or if they understand it and start trying to play games with it, even withholding becomes less voluntary.

That is why the confidence, and respect, and support is really extremely important in terms of people's willingness to comply.

We have a tax system that works but in the final analysis, we really do depend on individuals. Some may pay because they think if they do not we can come get them.

But when you look at 1 percent audit rates, when you basically look at a compliance gap that is still as large as it is, I think you begin to understand the importance of what we call our voluntary system. I think it tends to be.

Our competitor. I have talked about customer service. People have said hey, if it is customer service, Commissioner, you can go to a competitor. That competitor is right there, and it is the underground economy. It is the noncompliance gap.

Mr. ALEXANDER. I have to diverge a little bit from my good friend, Larry Gibbs, here. I think our system, as Larry eloquently pointed out, is based on voluntary compliance, and a voluntary compliance system has worked very well in the past and is working well today.

But I do not think it is a voluntary system. Back when I was in the tax shop I got letters occasionally saying take me off your mailing list. Do you get letters like that, Larry?

Commissioner GIBBS. The same person is still writing, Don.

Mr. ALEXANDER. The same person is still writing? Yes; well, I got several letters, and they were signing different names.

But I was sort of unable to do that. You cannot elect out of the system. The system is involuntary to that extent, but it is based upon the taxpayers' voluntarily self-assessing themselves in the first place, and it is also based—as Commissioner Gibbs pointed out—upon a strong withholding system, a strong information return system.

I am delighted that Commissioner Gibbs is succeeding in matching the magnetic tape that he receives. It was not a myth, Larry, back when we first started getting paper documents, they were not matched. So the system works well as long as people respect it, as long as people believe it is reasonably fair, and as long as people believe it is effectively enforced.

Chairman CHILES. As long as there are a couple of blackbirds hanging on the fence, you know that——

Mr. ALEXANDER. One or two, Mr. Chairman, yes, sir.

Chairman CHILES. Commissioner, I understand your definition of the $84.9 billion gap. It includes all income owed but not voluntarily paid. Therefore, it seems like all the amounts that IRS collects through enforcement programs like examination of tax returns, for example, could be deducted from the IRS estimate to arrive at the next tax gap.

I'm intrigued by one of the charts you prepared on the revenue from enforcement initiatives. It's that chart that shows——

Commissioner GIBBS. Yes; Mr. Chairman.

Chairman CHILES. If I read it correctly, it says that IRS projects $49.4 billion in enforcement revenue for fiscal year 1988.

Can I interpret that? Does that mean that we've cut the tax gap in half?

Commissioner GIBBS. Well, remember that the tax gap is an income tax gap. And as a result, the figures that you are referring to partly are composed of income tax that we obtain from enforcement. But there are other types of taxes as well. Again employment, estate and gift, excise, plus penalties and interest, are also included in those figures, and they are significant items. Plus the remittance amounts that come in as well.

So what I'm saying is when we reduce the income tax gap by the income tax that's collected from our enforcement activities, the accounts receivable and so forth, it doesn't equate completely to the $49 billion.

Chairman CHILES. Well, then I'm wrong to think that we cut the gap entirely in half.

In computing the gap figures——

Commissioner GIBBS. Mr. Chairman, I wonder if I could go back for just a second.

Since what we estimate is an income tax gap. In order to equate what we are reducing from collection activities, we have to look at the income tax receipts from compliance activities. It doesn't include other types of taxes.

And what I guess I'm saying is that when you look at the fact that it's an income tax gap, and you look at income tax receipts, they're approximately $20 billion.

Later this year, when our net tax gap estimates are available, we will be able to show you how much the gap is reduced by our overall compliance efforts in the income tax area.

Senator DOMENICI. Mr. Chairman.

Chairman CHILES. Yes, sir.

Senator DOMENICI. Could I ask one question?

Chairman CHILES. Yes, sir.

Senator DOMENICI. I have to leave.

I'm going to submit to the commissioner a question with reference to EPA's other credit situation, and you can answer it in due course.

Commissioner GIBBS. I'll be happy to.

Senator DOMENICI. It doesn't necessarily belong in this hearing, but we have an inconsistency, it seems like, between the Secretary of the Treasury and what the cities and counties are hearing your department may be doing.

[The following was subsequently supplied for the record by Commissioner Gibbs.]

TAX EXEMPT STATUS OF MUNICIPAL BONDS ISSUED TO FINANCE THE CONSTRUCTION OF WASTEWATER FACILITIES

Question

The EPA's decision to use a letter of credit rather than cash grants to capitalize the Water Pollution Control State Revolving Fund Programs achieves the dual goals of spurring state financial independence in wastewater facility construction and easing the federal government's outlay burden. There is speculation, however, that the IRS may rule that the SRFs, solely because the federal government is using a letter of credit, will act as a federal guarantee of municipal bonds used to finance wastewater facilities. This ruling could endanger the tax exempt status of these bonds, clearly thwarting the intent of the 1987 Clean Water Act amendments. Such a ruling would pressure Congress to force EPA to use a cash grant approach, causing a significant increase in the federal outlay burden.

Could you look into this issue, consult with EPA, and inform the committee as to your findings?

Answer

In conjunction with the Department of Treasury, the Internal Revenue Service has examined the issue concerning the tax exempt status of municipal bonds issued to finance the construction of wastewater facilities. Based on our review of this matter, the Internal Revenue Service issued the attached Notice 88-54 which indicates that IRS regulations will provide that payments of principal and interest on State and local bonds will not be considered Federally guaranteed solely by reason of the fact that the debt service reserve fund for the bonds may be funded with capitalization grants awarded under the Environmental Protection Agency's State Water Pollution Control Revolving Fund Program. The use of a letter of credit to capitalize the Water Pollution Control State Revolving Fund programs will not change this result.

Attachment

Application of IRC Section 149 (b) to State or Local Bonds Issued in Connection with EPA State Water Pollution Control Revolving Fund Program

Notice 88-54

This notice provides guidance regarding the application of section 149 (b) of the Internal Revenue Code to State or local bonds issued in connection with the State Water Pollution Control Revolving Fund Program under Title VI of the Clean Water Act (Program).

The Environmental Protection Agency (EPA) is authorized under the Program to make capitalization grants to States to help them establish State revolving funds for financing water pollution control facilities. The States may use the grants to make loans to local governments to finance the construction of water pollution control facilities, to establish debt service reserve funds for bonds the proceeds of which are to be used to make such loans, and for various other purposes.

On January 28, 1988, EPA issued final initial guidance relating to implementation of the Program (EPA guidance). The EPA guidance provides that payment of capitalization grants will be made in the form of a letter of credit in order to minimize the outlay burden on the Federal Government. States will draw down funds under the letter of credit in accordance with procedures outlined in the EPA guidance. If the grant is used to establish a debt service reserve fund for bonds, draw-downs generally will occur at a fixed rate based on the national, historic outlay rate. The draw-down rate will be accelerated if necessary to prevent an imminent default on the bonds.

Section 149 (b) of the Code generally provides that a State or local bond the payment of principal or interest on which is guaranteed (directly or indirectly) by the Federal Government or any agency or instrumentality thereof will not qualify for tax exemption under section 103 (a). Regulations to be issued under section 149 (b) will provide that payments of principal and interest on State and local bonds will not be considered Federally guaranteed within the meaning of section 149 (b) solely by reason of the fact that the debt service reserve fund for the bonds (or principal or interest on the bonds) may be funded with capitalization grants awarded under the Program in accordance with procedures outlined in the EPA guidance.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3 (b) of the Income Tax Regulations and may be relied upon to the same extent as a revenue ruling or revenue procedure. See Rev. Rul. 87-138, 1987-52 I.R.B. 17.

For Further Information Contact:

Susan Overlander of the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C., 20224 (Attention: CC:LR:T) (202-566-3829, not a toll-free call).

Senator DOMENICI. Let me ask just this one question.

Each year, from our constituents, that we hear about the cases where interpretations are at the heart of a tax dispute.

CPA groups and lawyers are saying to their clients that the law says A, and then IRS says the law says C. The taxpayer gets in a 3-year protracted legal argument over it, and that gets back to us in the form of how unreasonable, how lax the IRS is.

How much of the tax gap is the result of significant interpretative disagreements between taxpayers and IRS? I assume it's very small, but I would just like to get it if you have an idea about it.

Commissioner GIBBS. Well, again, where that would really come into effect, Senator Domenici, would be in the net tax gap, because that would be as a result of our compliance efforts.

This gross tax gap tries to measure the gap without regard to the impact of our compliance efforts, our examination disagreements with taxpayers, and so forth.

So it would—I think it's fair to say that in terms of the overall impact, in terms of reducing the tax gap, certainly a change in the complexity of the law, but also a change in the law itself is important in terms of affecting people's attitudes and willingness to pay.

What we are hearing more than anything else at the present time from practitioners and taxpayers is a frustration with respect to dealing with forms that seem to change every year as the law seems to change every year. I think it does have an impact on people's attitudes, perceptions and behaviors, and that certainly is reflected in the gap itself.

Senator DOMENICI. Well, I'm not capable of phrasing the question right, but I think the answer that you're giving me isn't right.

Ms. STATHIS. Senator, if I understand what you're asking, I think the answer is in the IRS estimate. They have a separate chart which projects the gap on the basis of assessed tax, the amount that would be assessed after appeal.

Is that what you're referring to?

Senator DOMENICI. May be.

Senator CONRAD. Yes, I think that is what his question, the thrust of his question really is that.

Ms. STATHIS. Now, the $84.9 billion is on the basis of tax that would be recommended by revenue agents. on the basis of what would actually be assessed, I think the estimate is $71.2 billion, and that is in the tax gap estimate report itself.

Commissioner GIBBS. I wonder if I could back because I may be wrong but, I thought the principal thrust was on the issue of whether we're basically taking positions that really are not well-founded in terms of disagreements with respect to others.

And I will simply say that I think a relatively small number of disputes actually go to the courthouse. So, for those that are able to afford it, I think the statistics in terms of the positions that we're taking are pretty good from the government standpoint, and in the appeals area as well.

I think what you're going to find is that you may have occasionally a situation where an agent takes a position that is not a reasonable position. I'm not going to tell you that doesn't happen, it does. But I think there are a relatively small number of the examinations issues where that occurs.

Mr. KURTZ. Senator Domenici, I think it's a much bigger problem for major corporations than it is for individual taxpayers.

In a large corporation audit program, there is a lot of tax that's recommended that ultimately doesn't get paid because of litigation, disputes, one thing or another.

In the individual area though, it strikes me that a very high percentage of recommened tax is ultimately assessed.

Chairman CHILES. The table that again we talked about, Commissioner, talked about the total compliance, but again, as you said, the only estimates that we had on these other charts for the income tax gap, how do you get this estimate of the total compliance if you don't have an estimate of the total gap, or do you have an estimate of total gap and we don't have that?

Commissioner GIBBS. No, we really don't. Those figures are actually derived and they honestly don't have anything to do with the tax gap estimate itself. Those are really total yield figures that we project from the standpoint of how to deploy the resources that we're given between collection and, examination—collection of certain taxes and, examination of certain types of tax returns. Income tax is certainly a large segment of it.

But you also have employment, estate and gift, excise tax, that type of thing.

And what we do is to basically take the resource allocation models and project if we were given the resources and applied them to collect the receivables and do the examinations leading to the tax, how we would configure those over the income tax area and the other tax areas, employment tax and excise tax, and what that would produce in the way of the revenue to the government.

Chairman CHILES. I'm trying to understand that.

Commissioner GIBBS. All right.

Chairman CHILES. And I'm trying to understand that you're saying that you don't have to have a model. But it seems like to me if you do something that says if we put X number of resource units into estate and gift, or any of these other returns, tax returns, you must have some kind of idea that there are X number of dollars out there that are not being collected now and we, therefore, think we would get a percentage of that if we put so many units out there.

Commissioner GIBBS. It is largely historical. In other words, we know from the past that if we have basically added agents in certain areas, or are examining returns, or collecting revenue, what we are able to produce. We can see, for example, in our accounts receivable, that there are accounts receivable that are not being worked; that if we had the resources, we could bring in more dollars.

Now, that doesn't translate, though, directly to a total tax gap.

Chairman CHILES. But right now you don't have any idea of what the size of the pool is that this $49 billion is a portion of?

Commissioner GIBBS. That's correct. And one of the things so that you'll know, we are taking a look right now at whether we think could do some additional work to give you a better idea in some of the other areas.

We don't have the data and the methods that are as good in those other areas as they are in the income tax areas. But, Mr.

Chairman, we are taking a look at that because we recognize the importance of it. And we will try to do what we can there.

Chairman CHILES. Well, in computing the corporate gap figures, IRS assumes that recent tax law change will have no effect, either positively or negatively, on the corporate voluntary compliance rate.

To the extent though that the new tax law increases corporate tax liabilities and, therefore, the incentive to cheat, it would seem likely that compliance could fall.

Given the fact that the IRS estimates for individual compliance will increase as a result of lower tax rate and simplified rules, wouldn't it follow that the corporate compliance would be unaffected by a substantially greater tax burden and additional tax rules?

Then, just to follow up, since that compliance rate is applied to corporate tax liability to estimate your latest gap returns, if it's your assumption that compliance will remain unaffected turns out to be incorrect, isn't it likely that the gap could be much greater than you anticipated?

Commissioner GIBBS. For individuals, we look at the voluntary compliance percentage, people that voluntarily report each item of income and each item of deduction. Once we do the audits for the prior year, we can project those by items of income, deduction and credit into the future. We don't have that capability in the corporate area. We don't have the data by item of income or by deduction or by credit in the corporate area.

So what we have to do when we are trying to estimate the corporate gap is we take a look at the overall compliance in a particular year that we've measured, where we've gone in and we've done audits. We have the information, we have the data, as to the overall compliance in the corporate area. It's not broken down by items of income and deduction. We just know that corporations in 1982 were about 82 percent compliant. They reported about 82 percent of the tax that was owed. We know that.

Then we project that on into the future. And we try to adjust that for tax law changes and so forth.

When we look back, we find that even though there were tax acts that were passed, that voluntary compliance rate for corporations has remained somewhat the same.

Chairman CHILES. But overall we've seen that compliance rate for corporations go from about 8 percent of the total to about 25 percent, have we not?

Commissioner GIBBS. When you look at the voluntary compliance rate of corporations as a whole though, it really does stay about the same.

Now, when we project that against greater tax liabilities, which is what we get when we look at the corporate area after the 1986 Act.

Chairman CHILES. Well, have you initiated any study of major reforms in compliance rates for corporations to determine whether or not you think they will?

Commissioner GIBBS. We are in the process of doing that so that we can allocate our resources. I think you will see us allocating more resources, Mr. Chairman, to the corporate area.

But let me give you the other side of it. In other words, what we're saying is we look at the past and the corporate voluntary compliance rate has been pretty much the same. We simply projected that voluntary compliance rate with some adjustments, against a greater corporate tax liability because we shifted tax from individuals to corporations in 1986.

Now, there is another argument. Another argument is, yes, the corporations have a greater amount of tax to pay. But look what you did in the corporate area. You basically repealed the investment tax credit, and you brought the rates down. Some people would argue that corporate compliance rates ought to go up for that reason because it's less easy to avoid the tax, because the investment credit, which was the largest portion, is no longer available, and the marginal rates have gone down.

So some people would say that voluntary compliance rates should get better for corporations after 1986. We're not able to measure that. We can't measure that and can't predict that. And with the amount of total tax liability, that is going to be increasing for the corporate sector, we're not prepared to make those kinds of assumptions because we can't do it methodologically and we're not sure that that's really what's going to show. We'll have to wait and see.

Chairman CHILES. IRS says, Ms. Stathis, that the tax gap has dropped about $30 billion since 1981.

I wonder if you put this number into a perspective. In GAO's view, what does a $30 billion drop represent?

Ms. STATHIS. I think that the drop represents a change in an estimation. The 1987 figure that was projected in 1983, obviously it's more difficult to project into the future than it is to estimate retrospectively. And because of those estimating differences, we have a different figure today.

Chairman CHILES. Well, how does GAO feel about the wisdom of excluding items such as the illegal income and remittances from the tax gap? Should they be included along with other types of non-income taxes as part of the gap?

Ms. STATHIS. Since one of the main purposes for estimating the gap is to understand where we have noncompliance and where we might want to develop strategies of enforcement, obviously then it would seem to make sense to include everything that we can in the estimate.

Chairman CHILES. Given IRS' increased resources, how much more revenue have the IRS enforcement programs generated and how helpful would more enforcement staff be in closing the tax gap? Can you give us any information?

Ms. STATHIS. I think I mentioned earlier we are doing a study for this committee on the exam resources. And it is difficult to come by actual revenues from any of these programs. There are some estimates, and we will be continuing to look at that as we do that study.

I think that it would be logical to say that some additional staffing would result in some closing of the gap. But I think there would be a question of——

Chairman CHILES. You can't quantify that?

Ms. STATHIS. I can't quantify it. And there would be some question of cost-effectiveness.

As we have also reported to this committee, there is some difficulty——

Chairman CHILES. Can you tell us whether IRS is utilizing their examination resources, their new resources in a way that would most effectively reduce the tax gap?

Ms. STATHIS. Well, we know, from our work, that in allocating exam resources among the various classes of returns, IRS does not exactly match them for the greatest revenue result. They have a concept of encouraging compliance across all categories. Therefore, there are some exam resources that go to classes that produce less in yield, producing less overall than they would if IRS put them all in some other classes.

Chairman CHILES. Commissioner, one of the intended benefits of the revenue initiative coverage was to increase audit coverage and thereby help to reverse the decline in voluntary compliance, the increase in the tax gap.

In the first budget for 1987, the first year of the initiative, IRS estimated an increase in audit coverage from 1.1 percent to 1.4 percent. A continued increase was projected in the 1988 budget in which the Service provides slightly upward its expected audit coverage for 1987 showing an estimate of 1.6 percent for 1988.

However, after 1 year of the initiative, IRS is now saying it only achieved 1.1 percent coverage in 1987. This decline, as I understand it, occurred even though the number of returns actually filed was less than the Service estimated. In addition, my understanding is now you're only expecting coverage of 1.2 percent next year, and likely stay below 1.3 percent even in 1989.

Why has this audit coverage not increased more? Is this a result of hiring problems?

Commissioner GIBBS. This is several things, Mr. Chairman.

One is an underrealization of staff for examination purposes in those years. It's a function of several things, particularly in 1987.

One, because of the budget situation in late 1986, we just were not able to—as a matter of fact, we were precluded from getting started with respect to our hiring as we went into 1987.

Secondly, we've had to absorb some of the examination revenues to fund other costs from a budget standpoint.

And, third, we've also had to reprogram, that is to say transfer resources away from examination and, for example, into processing returns and providing assistance to taxpayers.

So those are some of the reasons why we underrealized staff.

Another thing that we're encountering is that the returns are more complex, they're taking longer to audit, and we're not getting the tax shelters closed as rapidly as we had predicted in our estimates. Nevertheless, for 1987 and for 1988, we believe that we will produce the——

Chairman CHILES. Well, IRS examination staff was increased by 2,500 examiners in 1987, and again by 3,000 examiners in 1988. So how does the lower estimate of audit coverage mesh with those increased numbers of staff?

Commissioner GIBBS. Well, again, as I indicated, the combination of the three factors. Even though we received the additional resources, and we have used the additional resources in those years, it has taken us longer to close audits than we thought it would. The audits have been more complex than we estimated, and it has taken us longer to close even with the people we've received.

Chairman CHILES. Well, what staffing level would you estimate you need to achieve the 1.4 percent audit level that you assumed earlier for 1987?

Commissioner GIBBS. We can provide—we can—I don't have that information.

Chairman CHILES. If you would do that.

[The following was subsequently supplied for the record by Commissioner Gibbs:]

Question

What additional Examination resources would IRS need to achieve a 1.4% audit coverage rate?

Answer

Given that Examination can assimilate 2,500 staffyears per year, an audit coverage rate of 1.4% would be achieved by FY 1990 at a staffing level of 4,000 staffyears over FY 1989 Congressional levels. This projection would require additional staffing in FY 1989.

	Increased Staffing		
	FY 1989	FY 1990	Total
Coverage = 1.4%	+2,500	+1,500	+4,000

Chairman CHILES. How much would it take you to get up to the 1.6 mark? I'd like to know that too.

Commissioner GIBBS. I can answer it generally. It will take several years to get up to that kind of an audit coverage with the number of returns that we project will be coming in, and with our experience in terms of closing the exams.

I will tell you this, we're raising more per case than we had originally estimated as well. And that's why the dollars are——

Chairman CHILES. I'd like to have your estimate or your feeling, and, Mr. Alexander, yours, Mr. Kurtz too, what is the optimal level? What percent of audits should we be examining?

Mr. ALEXANDER. Three percent.

Mr. KURTZ. That's what I had in mind.

Chairman CHILES. Is that it?

Mr. KURTZ. When I was there, it was at 2.6 percent—I guess started at 2.6 percent, then declined to about 2.4 percent by the end. But I always felt there was a little bit more to do.

Chairman CHILES. How much effectively?

Mr. KURTZ. And it's hard to think that 3 percent is intrusive. I mean that's still at a low enough level as to not be intrusive.

Chairman CHILES. What was it when you——

Mr. ALEXANDER. 2.6 percent. Got it to that. It was lower than that when I started off in 1973. By the end of 1976, we got it to 2.6 percent which I thought, as Jerry Kurtz just said, should have been increased to some extent.

Chairman CHILES. Well, it's pretty obvious to anyone that 1.2 percent isn't enough. We're not hanging crows from the fence at that rate.

Mr. ALEXANDER. It's not enough. They are doing some things that we weren't doing.

Chairman CHILES. The screening and some of the——

Mr. ALEXANDER. Well, the contacts from service centers which are helpful, but they're not full substitutes for audits.

Chairman CHILES. Well, our time is up. We have taken a lot of your time.

We might have a few questions for the record to submit to you.

Commissioner, I'm very interested in paperwork, and I have some questions on that. And my understanding is we didn't exactly prepare you for those, and so I won't raise those right now, other than to say that I do look forward to getting a chance to sit down with you or something.

Commissioner GIBBS. I will welcome the opportunity to chat with you about that.

I would simply like to very quickly assure you that we are concerned about the impact of tax forms and paperwork on the public. And I would like to come and talk to you about some of the recent events to explain where we are coming from and what that concern means.

Where I'm really coming from with respect to some of the initiatives, with respect to the paperwork reduction act. And if you and your staff would have the time, I would be delighted to come down personally and basically talk to you about it. Because I share your concern.

Chairman CHILES. I'll look forward to that. And we thank you for your appearance and certainly were delighted to see former commissioners that look like they're able to at least manage the same salary that they got while they were Commissioners. [Laughter]

Thank you very much.

Commissioner GIBBS. Thank you, Mr. Chairman.

[Whereupon, at 12:26 p.m., the committee recessed, to reconvene at the call of the Chair.]

WRITTEN QUESTIONS FROM SENATOR CHILES TO COMMISSIONER GIBBS AND THE RESPONSES

Question

What is the correspondence inventories at Service Centers and within the National Office?

Answer

The Adjustments/Correspondence inventories at IRS Service Centers were 484,545 as of April 15, 1988 compared to 568,866 as of April 17, 1987. The correspondence inventory at the National Office at the beginning of April 1988 was less than a thousand cases.

Question

This year, I understand that dependents over 5 years of age are required to have a social security number on their parents' 1040 tax form, and that of course dependents income if it exceeds a certain amount, will trigger a separate filing for that dependent.

Are you getting more tax returns filed this year because of this 1986 tax law change, and are you finding as a result that maybe dependent income has been underreported in the past?

Answer

Prior to the start of the 1988 filing season, IRS projected that over 3 million new taxpayers will file returns because of the repeal of the personal exemption for dependents who can be claimed on their parents' return. (We also projected from our research that over 2 million low income filers will no longer be required to file returns this year because of the tax reform changes such as the increase in the personal exemption and standard deduction.) Through April 22, 1988 nearly 95 million individual income tax returns have been filed of which 8.2 percent were filed by dependents. Comparable statistics for the percentage of dependent filers for the prior year, however, are not available.

We have not had a chance to examine the dependent returns filed under the new rules or related prior year returns to determine if dependent income was unreported in the past. However, we will institute a program to monitor taxpayer compliance with these requirements.

In past years, we have conducted an IRP matching program to identify non-filers and returns with significant underreporting of income. Furthermore, we recently initiated a program to identify minor children with passive income who were filing a return and claiming the zero bracket amount deduction in excess of their earned income. In these cases, we disallowed the excess zero bracket amount deduction.

In addition, TCMP results for individuals for tax year 1982 (the latest year currently available) indicate that the voluntary reporting level for interest income was 97.0% and for taxable dividends it was 96.5%. Historically, income subject to 1099 reporting has a high level of compliance.

Question

In just 15 days the American taxpayers will be required to file their taxes. I'm concerned about some press reports that filings are running behind where they were at this time in previous years.

First, maybe you could comment on the current status of filings for the 1987 tax year.

But more importantly, I wonder if late filings, at least for those who are filing later this year might not have something to do with increased complexities in the tax forms this year brought about by the 1986 law changes. You know, I think we referred to the 1986 law changes as Tax Simplification.

If complexities cause errors, then by your definition the tax gap will increase.

Answer

The 1988 filing season is progressing extremely well and return filings are now ahead of last year's pace. Through April 22, 1988, the IRS has received 94.9 million individual income tax returns compared to 93.8 million as of April 24, 1987. We have processed 64.1 million returns this year compared to 63.8 million last year. In addition, through April 21, 1988 over 50 million refunds have been issued, with the average refund of $842.45 being slightly higher than last year.

We have identified a slight increase in taxpayer errors this filing season. However, the tax gap need not increase simply because taxpayers are making more errors on their returns due to tax reform. If taxpayers are making genuine errors, in the aggregate, the errors should cancel out. After tax reform, while some individuals may end up making more errors in their favor rather than in favor of the government, others may become more compliant in reporting their taxes because they find that their tax obligations have decreased.

In preparing our tax gap estimates we recognized that there would be perhaps offsetting tendencies of this type which would be difficult to quantify. For individuals, tax gap estimates are based on the assumption that, in general, the voluntary reporting rate for each source of income, each deduction, exemption, adjustment, or credit claimed will remain constant. To the extent that tax reform eliminates, restricts, or phases out a number of subtractions from individual income, taxpayers can no longer overstate these items. Such changes which reduce the tax gap were built in the calculation of the gap. However, no attempt was made to estimate the more subtle effects tax reform may have on individual attitudes and reporting behavior. The exception to this rule is that compliance was assumed to improve in response to TRA's introduction of more information reporting.

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